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ABSTRACT

Suggestions and guidelines to help school administrators, business officials, board members, and others interested in improving school facilities are presented in this book. Chapter 1, "School Building Programs, Equipment Acquisition: The Anatomy of School Debt Financing" (Edgar H. Bittle), provides an overview of the legal and planning issues that school boards face. Chapter 2, "Planning and Constructing School Facilities" (Arlis Swartzendurber), provides practical insights from a school administrator for planning and implementing capital improvement projects. Chapter 3, Typical Problems in School Building Programs, An Architect's Perspective (L. Bradford Perkins), offers an experienced architect's insights concerning the planning process. Financial concerns that school districts face in planning a capital improvement project are detailed in Chapter 4, "Development and Implementation of the Financing Plan" (Jeanne Frederick Vanda, Christopher M. Gibbons). Chapter 5, "Accessibility of a Public Entity's Facilities under the Americans with Disabilities Act," (Janet Little Horton, Christopher B. Gilbert), outlines the considerations for complying with the Americans with Disability Act in building or renovating a building. Chapter 6, "Fundamentals of Competitive Building" (Edgar H. Bittle, Elizabeth A. Grob), is an overview on how to conduct competitive bidding including the requirements of public sector bidding. The last two chapters, "A Federal Tax Law Primer for School Finance Officials" (Michael K. Reppe) and "A Federal Securities Law Primer for School Finance Officials" (Dennis L. Holsapple, Jeffrey S. Ballard), present a detailed summary of the federal tax and securities laws, which govern the marketing of securities for financing capital improvement projects. (Includes an index.) (RJM)

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# Planning and Financing School Improvement and Construction Projects

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*Edited By*
*Edgar H. Bittle*

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NOLPE

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**Published in cooperation with the American Bar Association**

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# Planning and Financing School Improvement and Construction Projects

Edited By

Edgar H. Bittle

National Organization on Legal Problems of Education

and

American Bar Association
Section of
State and Local Government
Public Education Committee

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The purpose of this publication is to identify issues. It does not purport to be exhaustive or to render legal advice. You should consult with qualified counsel or other professionals in developing responses to specific situations.

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# Foreward

This book grew from presentations made in 1986, 1991, and 1993 to the International Association of School Business Officials, the 1992 Annual Meeting of the National School Boards Association Council of School Attorneys, the Iowa School Business Officials Academy at Iowa State University, and the 1994 NOLPE Convention. The authors are all experienced professionals who have been involved with planning school building and improvement programs. They have combined their talents and experiences to produce this practical guide for school administrators, business officials, board members, attorneys, architects, and others who are involved with school facilities planning. Students and professors of education law should also find this a helpful resource.

Chapter one is an overview of the legal and planning issues that face a school board and its administration in planning and financing a capital improvement project. Chapter two provides practical insights from a school administrator for planning and implementing a capital improvement project. Chapter three provides the insights of an experienced architect and advice to school "owners" about the planning process.

Chapter four details the financial considerations facing a school district planning a capital improvement project and a practical road map in the financial process. Chapter five outlines the considerations for complying with the Americans with Disability Act in building, or renovating a building. Chapter six is an overview of the competitive bidding process. Board members with experience in the private sector, frequently are baffled by the requirements of public sector competitive bidding. This chapter seeks to set forth those requirements, and to provide some insight into the underlying public policy which is to protect the integrity of the bidding process from fraud, favoritism, and corruption.

The last two chapters, written by Mike Reppe and Dennis Holsapple of the Kutak Rock law firm, provide a detailed summary of the federal tax and securities laws which govern the marketing of securities for financing capital improvement projects. Mike has been underwriter's counsel to the Iowa School Cash Anticipation Program for eleven years, and he and I have worked together during that time to provide practical solutions for school financings. These chapters are not designed for light bedtime reading, but do provide a useful reference for school administrators and business officials to help them understand the requirements of the federal tax and securities laws.

Thanks to the many who have provided assistance and encouragement for this project. My partner Philip Dorweiler helped develop the basic outline for our presentation at the ASBO Annual Convention in 1991 which ultimately became Chapter one. Dr. William Posten, Profes-

sor and Director of the Iowa Association of School Business Officials Academy at Iowa State University encouraged the development of a curriculum for the School Business Officials Academy. Floyd Delon, recently retired Executive Director of NOLPE, and Larry Etheridge, publications director for the ABA State and Local Government Section, encouraged the development of a program that could become a practical, "how to do it" book. My colleague of eleven years in the Iowa School Cash Anticipation Program, Mike Reppe, agreed to write the most difficult chapter as part of our NOLPE San Diego presentation. He recruited Dennis Holsapple and Jeff Ballard to write the chapter on securities law which has been a moving target as new regulations have been developed this past year. Jeanne Frederick Vanda, financial adviser to the Iowa School Cash Anticipation Program agreed to write the chapter on financial planning with the assistance of her colleague, Christopher Gibbons. When I showed a manuscript to friend and Cornell fraternity brother, Brad Perkins, he offered to write a chapter from the architect's perspective. Friend, client and fellow Academy faculty member Arlis Swartzendruber stepped forward to write the planning chapter drawing on his experiences and his teaching materials at Iowa State and Drake University. Janet Horton took time from her busy schedule to contribute the chapter on ADA compliance and to be part of the San Diego faculty. My secretary, Sharon Zagers, associate Merle Fleming, and law clerk Beth Grob have typed, proofed and edited the manuscripts and provided valuable encouragement and suggestions throughout the project. Dr. Lelia B. Helms, Professor in the Division of Planning, Policy and Leadership Studies at the University of Iowa and chair of the State and Local Government Sections Public Education Committee's Report and Publications Committee provided valuable insight and suggestions. Larry Etheridge, who began his career working on the ABA Model Procurement Code project and is now Secretary of the State and Local Government Section, and Sandra Van de Walle, on the legal staff of the Port Authority of New York and New Jersey and member of the ABA State and Local Government Council provided valuable comments on the competitive bidding chapter and overall concept for the book.

During my term as Chair of the Public Education Committee of the ABA State and Local Section, ABA and NOLPE forged a partnership that has produced joint programs at the NOLPE annual meeting. The Section of State and Local Government has produced many practical programs for local government attorneys. Since its founding in 1954, NOLPE has encouraged a multidisciplinary approach to education law. This book and the collaboration which produced it are in furtherance of that tradition.

Edgar H. Bittle

## About the Authors

***Edgar H. Bittle*** is a partner in the law firm of Ahlers, Cooney, Dorweiler, Haynie, Smith & Allbee, P.C. in Des Moines, Iowa. He has been chairman of the Public Education Committee of the American Bar Association's State and Local Government Section, is chairman of the legal faculty of the Iowa School Business Officials Academy at Iowa State University, served as chairman of the NSBA Council of School Attorneys in 1980-81 and has served on the Board of Directors of the National Organization on Legal Problems of Education. He is counsel to the Iowa Association of School Boards, the Iowa School Cash Anticipation Program, the Iowa Schools Joint Investment Trust, the Iowa Association of School Business Officials and many schools in Iowa. Mr. Bittle has a B.A. in Government from Cornell University and a J.D. from the University of Michigan. He has authored many books, articles and monographs for several professional organizations.

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***Michael K. Reppe***, a partner in Kutak Rock's Denver office, joined the firm in 1983 after four years in the U.S. Army Judge Advocate General's Corps as an administrative and contract law adviser. Mr. Reppe has participated in numerous bond and note financings, representing dozens of issuers in the western United States. He has provided legal services in connection with public finance transactions for numerous school districts, including pooled financings for the California School Cash Reserve Program Authority, the California School Boards Association Finance Corporation, the Utah School Boards Association, the Idaho School Boards Association, the Arkansas School Boards Association, the Iowa School Cash Anticipation Program, the Nebraska School Boards Association and the Texas Association of School Boards. Mr. Reppe earned his bachelor's degree, magna cum laude, from Arizona State University in 1986 and his law degree from the University of Nebraska Law School in 1979 (Order of the Coif).

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# SCHOOL BUILDING PROGRAMS, EQUIPMENT ACQUISITIONS: THE ANATOMY OF SCHOOL DEBT FINANCING*

**Edgar H. Bittle**
**Ahlers, Cooney, Dorweiler, Haynie, Smith & Allbee, P.C.**
**Des Moines, Iowa**

## I. Introduction

A high quality learning environment is crucial to educating the nation's youth. However, since 1965, studies have shown that America's schools are in substandard condition.[1] "Decent facilities" are defined as those that are ". . . structurally safe, contain fire safety measures, sufficient exits, an adequate and safe water supply, an adequate sewage disposal system, sufficient and sanitary toilet facilities and plumbing fixtures, adequate storage, adequate light, be in good repair and attractively painted as well as contain acoustics for noise control."[2] States and localities generally are responsible for financing the construction and repair of school facilities.[3] As a result, the cost of school building projects are often financed by some type of debt mechanism authorized by state law. The Congress and the Treasury Department of the United States consider tax-exempt financing as a form of subsidy and regulate the issuance of bonds, the investment proceeds, and the spending of bond proceeds to accomplish the governmental purpose for issuing the bonds and to prevent abusive transactions. The Securities and Exchange Commission regulates certain aspects of the sale and marketing of school bonds and other school debt instruments to the public.

## II. School Building Programs and Bond Issues[4]

### A. Generally

Undertaking a capital improvement program and issuing school bonds is a time consuming process. It requires many decisions and involves not

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[1] G.A.O., *School Facilities-Condition of America's Schools*, Feb. 1995.

[2] *Id.* (citing Pauley v. Kelly, No. 75-C1268 (Kanawha County Cir. Ct., W. Va., May 1982); Edgewood Indep. Sch. Dist. v. Kirby, N. 362, 516 (259th Dist. Ct. Travis County, Tex., June 1, 1987), *rev'd.* 761 S.W.2d 859 (Ct. App. Tex. 1988), *rev'd* 777 S.W.2d 391 (1989)).

[3] *See also* The Education Infrastructure Act of 1994 Pub. L. No. 103-382 (Oct. 20, 1994).

[4] Adapted from a presentation by Philip J. Dorweiler and Edgar H. Bittle at the Association of School Business Officials International Annual Meeting (New Orleans, La., Oct. 27, 1991) (discussing school building programs). An adaptation of that presentation was published in 58 Sch. Bus. Aff. (Feb. 1992), School Law in Review, NSBA Council of School Attorneys, and 73 Educ. L. Q. 593 (June 4, 1992).

only school board members and administrators, but also the district's bond counsel, financial consultant, architect, engineer and investment banker.

If current funds or accumulated invested funds are not sufficient, whether debt financing is feasible must be determined. A school district must determine the legal means by which the project can be accomplished, and must structure the debt financing in the most cost efficient manner. A consulting architect or other consultant may be retained to assist the committee to define the project scope. In addition a citizens' committee may establish a "wish list." The board and the administration, in conjunction with retained architects and consultants, perhaps working with a committee, can then determine what is feasible and necessary. The board must prioritize needs and decide whether there should be one project or several projects.

If an election is necessary to approve the project, this planning should be done in a way that will encourage broad community support for the proposition when it is presented to the electors. During this preliminary planning, the district must evaluate its financial capability for supporting the building program. Bond counsel and the financial consultant should review constitutional and statutory debt limitations and the current amount of outstanding general obligation or other debt of the district to determine whether the amount of the proposed project is within the debt capacity of the district.

If there is outstanding debt, the total annual principal and interest requirements and debt service for the proposed project must be determined. If there are statutory tax limitations, a determination is necessary as to whether the remaining taxing authority is sufficient to retire principal and interest on the proposed bonded indebtedness.

Board members, administrators, and others involved in developing a building and financing plan will need to be aware of the legal and financial implications of "debt financing" in the context of the legal requirements of debt, tax and funding mechanisms, competitive bidding requirements and necessary contracts to accomplish the project. Members of a citizens' committee, for example, may be frustrated if they do not understand the legal restrictions under which public schools must operate.

"A 'debt' includes every obligation by which one person is bound to pay money to another."[1] When used in the constitutional sense, it is given

[1] Iowa Hotel Ass'n v. State Bd. of Regents, 114 N.W.2d 539, 543 (Iowa 1962) (quoting Buena Vista County v. Marathon Sav. Bank, 196 N.W. 729 (Iowa 1924), *aff'd on reh'g*, 200 N.W. 199 (Iowa 1924)).

a meaning far less comprehensive than it bears in general use.[6]

Bonds payable out of specified revenues are excluded from the definition of "debt." For instance, bonds payable from the revenues of dormitory fees that are used to finance the construction of a dormitory might be revenue bonds under state law, and not "debt" for constitutional and statutory debt purposes.[7]

Generally, school districts issue general obligation bonds secured by the full faith and credit and general taxing power, usually ad valorem property taxes, of the school district. Most state laws prohibit liens on school district property. Rather, general obligation school bonds are secured by the unlimited taxing power of the school district. If the school district fails to raise taxes sufficient to pay for debt service on general obligation bonds, the school district may be compelled by court order to levy amounts sufficient to pay principal and interest on the bonds.[8]

Before incurring debt, a school district must have express statutory power to do so, and the exercise of the power must not violate statutory or constitutional debt limitations. During the 1880s, communities competed to bring railroads to their areas by issuing bonds to finance these major projects. In the panics of 1837, 1855 and 1857, many of those railroad bonds were defaulted as a result of railroad bankruptcies. Consequently, debt limitations were enacted by states through statute and constitutional amendments. These actions limited the amount of debt a municipality could incur, specified procedure to be followed to incur debt, and prohibited loans of credit to private enterprise. Thereafter, the private section financial community demanded legal opinions that municipal debt was valid and enforceable. The financial community employed specialized attorneys who were knowledgeable in the scope and application of debt limitation enactments. The acquisition of municipal debt was contingent upon the opinions issued by these attorneys, the forerunners of modern bond counsel.[9]

Contingent obligations may not constitute debt, and thus may not fall under the debt limitation laws. A contingent obligation is not backed

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[6] Farrell v. State Bd. of Regents, 179 N.W.2d 533, 543 (Iowa 1970); Hubbell v. Herring 249 N.W. 430 (Iowa 1933); State v. Thone, 286 N.W.2d 249, 254 (Neb. 1979); Rochlin v. State, 540 P.2d 643, 647 (Ariz. 1975).

[7] Farrell v. State Bd. of Regents, 179 N.W.2d 533, 543 (Iowa 1970).

[8] *See generally* 15 McQuillin Mun. Corp. (3d ed. 1990); 64 Am. Jur. 2d *Public Securities and Obligations*; County of Mitchell v. City Nat'l Bank, 91 Tex. 361, 43 S.W. 880 (1898).

[9] National Ass'n of Bond Lawyers, *Fundamentals of Municipal Bond Law* 17 (1991). *See also The Functions and Professional Responsibility of Bond Counsel*, Nat'l Ass'n of Bond Lawyers, Model Bond Opinion Project, 1987.

by the full faith and credit of the school district and the unlimited power to levy a tax to pay the debt. Lease-purchase financing used in some states is an example of such contingent financing. When equipment or facilities are acquired or built on a lease-purchase basis, the school district agrees to pay the annual lease payment. A portion of each payment is allocated to the payment of interest and the balance is allocated to the repayment of principal. However, the school district may cancel the lease in any year if funds are not available. (If the payment is not made, the seller can repossess the equipment and there are no further payments due.) At the end of the lease term, the school district has the option to pay an additional sum to purchase the equipment or facilities. As will be discussed below, there must be express statutory power to do the transaction in the first instance.[10]

Almost all states uphold leasing as a valid financing mechanism not subject to statutory or constitutional debt limits.[11] Because the obligation does not create an immediate liability scheduled to come due during the lease term but only a liability to the extent of value received, the lease does not create an "indebtedness."[12]

## B. "Dillon's Rule"

Debt issued in violation of a debt limitation is void.[13] Likewise, unless a school district has home rule powers, under "Dillon's Rule" a school district has only the power granted by statute or necessarily implied from the state constitution and statutes. Contracts made without statutory power are ultra vires and void.[14]

Short-term obligations to be paid from revenues collected for the fiscal year are generally treated in the same way as cash transactions and

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[10] Cray v. Howard Winneshiek Community Sch. Dist., 150 N.W.2d 84 (Iowa 1967); Porter v. State Bd. of Pub. Instruction, 144 N.W.2d 920 (Iowa 1966) (holding state statute directly authorized renting a school room); Buechele v. Ray, 219 N.W.2d 679, 681 (Iowa 1974) (determining "It is the nature of the act . . . which determines [the nature of] a function"). *See also infra* part III.

[11] Governmental Obligations, Bond Attorneys' Workshop, part 1 at 17 (1994).

[12] Tax Exempt Lease Financing, Bond Attorneys' Workshop, part 9 at 2 (1993).

[13] Bradford v. San Francisco, 112 Cal. 537, 44 P. 912 (1896); Windsor v. Des Moines, 110 Iowa 175, 81 N.W. 476 (1990); Stanley v. Fitzgerald, 509 N.W.2d 454 (Iowa 1993). *See also* Wein v. State, 347 N.E.2d 586, 592 (N.Y. 1976) (holding "[I]f repayment of tax and revenue anticipation notes may only be made by creating, directly or indirectly, a budgetary deficit in the year of repayment, such borrowing is not an anticipation of the receipt of taxes and revenues and thus violates constitutional limitations").

[14] Nevarov v. Nevarov, 133 Cal. App. 2d 457, 284 P.2d 17 (1955); Porter v. State Bd. of Pub. Instruction, 259 Iowa 571, 144 N.W.2d 920 (1966); Cray v. Howard Winneshiek Community Sch. Dist., 260 Iowa 465, 150 N.W.2d 84 (1967); Chemical Bank v. Washington Pub. Power Supply Sys., 99 Wash. 2d 772, 666 P.2d 329 (1983). *See infra* part III.

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are not debt. Revenues that are to be provided by tax levies and that are in the process of collection are regarded as constructively within the state treasury.[15]

"Debt," then, as a term of art, may have different meanings in different contexts. The purpose of this chapter is to outline for practitioners the general implications of "debt financing," in the context of other school district operating considerations. The role of local school district counsel is to advise the local school board and administration on the avoidance of illegal debt, and to work in conjunction with bond counsel in planning debt financing mechanisms.

Early in the planning process, if an architect has not already been employed, the district should employ an architect.[16] One of the toughest situations a school district can face is to struggle for several years in varied attempts to obtain approval of a bond issue to fund a project and then, at last, having succeeded to discover that the amount approved is insufficient. Construction costs change, sometimes rather quickly. Failure to adjust the estimates in response to rising prices or changes in the scope of a project as needs change can create delay and added expense. For these reasons, an architect should be involved in the pre-election planning to help define the scope of the project and to make a preliminary estimate of the construction costs.[17]

A financial consultant should also be involved at this phase to help compile financial data and to prepare projections and related calculations as to the structure and cost of the bond issue. The disclosure guidelines under Rule 15c2-12 of the Securities and Exchange Commission impose disclosure obligations on schools that are similar to those that private security issuers have followed for years.[18] At the time of the sale and issuance of bonds, the school district must provide all data that may be material and relevant to potential purchasers of the bonds.[19] Assembling the required detail and information, and performing the due diligence required in each prospectus is the responsibility of the financial consultant.[20] After the bonds, notes or other debt instruments are issued, the 15c2-12 regulations require ongoing disclosure so long as the bonds

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[15] *In re* State Warrants, 6 S.D. 518, 62 N.W. 101 (1895); Rowley v. Clarke, 162 Iowa 732, 144 N.W. 908 (1913).

[16] *See* NSBA Council of School Attorneys, Contracting with Architects: A School District's Prospective (1991).

[17] *See infra* part III.

[18] 17 C.F.R. § 240.15c2-12 (1991).

[19] Public Securities Ass'n, New York, Fundamentals of Municipal Bonds ch. 9 (4th ed. 1990).

[20] *Id.* at 28-29.

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are outstanding.[21] Indeed, if a financial consultant is not used, compiling this disclosure information may be the "straw that breaks the camel's back" for a district's business office.

Bond counsel should be involved as early as possible in the planning process to ensure that all prerequisite action is taken at the right time and in the right order, that these actions are formally recorded, and that they are carried out legally, so that a complete "transcript" of the proceedings authorizing the indebtedness is available.[22] This is necessary so that an unqualified legal opinion can be given to the purchaser of the bonds that the bonds are legal, valid and binding obligations of the school district, that taxes or other revenue are authorized to pay principal and interest on the bonds, and to ensure that the interest on the bonds is exempt from federal income tax.[23]

If there are potential problems with the site, particular design problems (such as those related to mechanical or air conditioning tie-ins to an existing building), or environmental concerns (e.g., asbestos in an existing building, underground storage tanks or other environmental problems), a consulting engineer may need to be retained to work with the architect in doing the planning.

Architects and engineers will ordinarily work for a defined fee during this planning process for a specified amount of work. Bond counsel will ordinarily work for a fixed or hourly fee for work during the planning and election process, incorporating that work into the total fee for the bond issue if the proposition passes. Financial consultants generally charge a fee at the time bonds are issued. Bond counsel and financial consultant fees are generally based on the completion of the project, the complexity of the financing, and the amount of bonds to be issued.

## III. The Power to Tax, the Power to Contract, and the Power to Spend

A school district generally has only the power granted by statute or necessarily implied in governing statutes.[24] A school district cannot do

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[21] *See infra* ch. 8.

[22] *See supra* note 9. *See also* National Ass'n of School Bds., The School Attorney: A Practical Guide to Employing School District Legal Counsel (Edgar H. Bittle ed., 1986).

[23] *See infra* chs. 7 and 8.

[24] *See generally* 68 Am. Jur. 2d *Schools* § 50; Bishop v. Iowa State Bd. of Pub. Instruction, 395 N.W.2d 888, 891 [35 Educ. L. Rep. 784 (Iowa 1986)]; Pleasant Valley Educ. Ass'n v. School Dist., 449 N.W.2d 894, 897 [58 Educ. L. Rep. 269] (Iowa Ct. App. 1989); McFarland v. Board of Educ., 277 N.W.2d 901, 906 (Iowa 1979).

indirectly what cannot be done directly. For instance, a lease with an option to purchase a school building was held beyond the authority granted by statute to contract, and consequently the lease purchase agreements were also held invalid as an attempt to do indirectly what the board could not do directly.[25]

School districts have the power to contract.[26] However, the district's power to contract is limited to that expressly or impliedly authorized by statute and may be subject to constitutional or other statutory restrictions. Where the contract entered into is beyond the scope of the district's power, the contract is unauthorized and may be void as against public policy.

The power to tax is narrowly construed. A taxing statute is construed liberally in favor of the taxpayer and strictly against the taxing body.[27] However, courts do give weight to administrative interpretation of statutes even though it is well settled that in the interpretation of taxing statutes, doubtful language is to be resolved in favor of the taxpayer and against the taxing body.[28]

## IV. Elections–Bond Referendum

When a school district submits a bond proposition to the voters, all statutes regulate those procedures which must be followed. For example, one court held that a variance between the petition and notice of stated purpose for an election and the stated purpose on the school bond election ballot was fatal to an election and declared void.[29]

The purpose for which a tax levy is approved by voters cannot be expanded.[30] Following a vote in favor of a proposition submitted to the voters for incurring a debt for a particular purpose, the debt cannot be incurred or the money expended for a different purpose.[31] The vote of the people is final and conclusive. If the voters of the school district have approved a bond issue for schoolhouse purposes, the voters of the district cannot later rescind their action.[32]

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[25] Cray v. Howard Winneshiek Community Sch. Dist., 260 Iowa 465, 150 N.W.2d 84 (1967); Porter v. Iowa State Bd. of Pub. Instruction, 259 Iowa 571, 144 N.W.2d 920, 924 (1966).

[26] 78 C.J.S. *Schools & School Districts* §§ 399, 403(a) (1995). *See infra* ch. 6.

[27] Scott County Conservation Bd. v. Briggs, 229 N.W.2d 126 (Iowa 1975).

[28] General Expressways, Inc. v. Iowa Reciprocity Bd., 163 N.W.2d 413, 423 (Iowa 1968). *See also* McQuillin Mun. Corp. §§ 44.12-.13 (3d ed. 1990).

[29] *See generally* 64 Am. Jur. 2D *Public Securities and Obligations* §§ 124-79; Honohan v. United Community, 258 Iowa 57, 137 N.W.2d 601 (1965).

[30] Manning v. City of Ames, 184 N.W. 347 (Iowa 1921); Paul v. Marshall County, 216 N.W. (Iowa 1927); H.L. Munn Lumber Co. v. City of Ames, 176 N.W.2d 813, 818 (Iowa 1970).

[31] McQuillin Mun. Corp. § 44.0.18.

[32] Looney v. Consolidated Indep. Sch. Dist. of Cromwell, 205 N.W. 328 (Iowa 1925); *see, e.g.*, Bredt v. Franklin County, 290 N.W. 669 (Iowa 1940).



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If an election is required to approve the bond issue, after the board and administration have decided to propose the bond issue, but prior to a final decision to proceed, the board should provide the public with as much information as possible to encourage voter participation. Holding public hearings provides voters an opportunity to ask questions and to present information to the board that may not have been considered, and gives the board an opportunity to provide information on the district's critical needs to the voters.

A common restriction on the school board and the school district in making the presentation on the bond issue to the public requires the board's campaign to be informational only. A district can provide information to the taxpayers and urge them to vote on a particular day, but it cannot expend funds to urge them to vote "yes" or "no."[33] The district's staff can be available to furnish facts and figures. A citizens' committee is one method which may be effective if it is carefully selected. Unlike the district, a citizens' committee may promote a proposed bond issue and urge a "yes" vote. If a petition from voters is required before a board can submit a bond issue to voters, the petition process provides an opportunity for formation of a citizens' committee at an early state in the effort. The district can facilitate these committees, but the district cannot provide resources to encourage the "yes" or "no" vote. These committees may also be subject to state campaign disclosure laws.[34]

## V. Issuance Decisions

If the election is successful, or in cases where the debt does not require an election, the financial consultant and bond counsel begin to sell and issue the bonds. The following is a list of decisions that must be made and procedures that must be completed.

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[33] Mountain States Legal Found. v. Denver Sch. Dist., 459 F. Supp. 357 (D. Colo. 1978); Anderson v. City of Boston, 376 Mass. 178, 380 N.E.2d 628 (1979); Stanson v. Mott, 551 P.2d 1 (Cal. 1976); Elsena v. City of Chicago, 334 Ill. 78, 165 N.E. 129 (1929); Leonard v. Iowa State Bd. of Educ., 471 N.W.2d 815 [69 Educ. L. Rep. 532] (Iowa 1991).

[34] *See* F.D. Ethredge, National Ass'n of Sch. Bds., How to Win Elections for Your Schools and for Yourself (1989); Carleton R. Holt, *Critical Factors That Affect the Passage of School Bond Elections*, Sch. Bus. Aff. (Aug. 1994). The Iowa Campaign Disclosure Law provides: The governing body of a county, city or other political subdivision of the state *shall not expend or permit the expenditure of public monies* for political purposes, *including* supporting or opposing a ballot issue. This section shall not be construed to limit the freedom of speech of the governing body of or the officials or employees of the governing body of, a county, city, or other political subdivision of the state. Iowa Code § 56.12A (1993) (emphasis added).



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### A. Plans Should Be Made for All Contract Lettings.

In contracting with the architect or engineer, the board members should have in mind a timetable for the design and completion of the project. Once the board has decided to proceed with the financing, the architect or engineer should be given authority to proceed, and plans should be made for selling and issuing bonds. Before plans are completed, school district legal counsel should review the contract documents.

### B. When Will the Bonds Be Sold?

There are several factors which may affect this decision. If a district needs to issue more than $5,000,000 of debt, it may be wise not to issue some or all of the bonds until the next calendar year. Such delay permits the school district to take advantage of an exception to the arbitrage rebate rules of the Internal Revenue Code of 1986, as amended (the "Code") for issuers who issue less than $5,000,000 of tax-exempt obligations during a calendar year.[35] Without the benefit of this exception, or other exceptions discussed below, whenever the investment rate of return on bond proceeds exceeds the interest rate on the bonds that are issued, the school district must rebate the excess earnings to the federal government.[36]

If a school district issues more than $10,000,000 of tax-exempt debt in a calendar year, the bonds issued are not "bank qualified." If there is a strong banking community in the state that bids on bond issues, financial institutions need to know that the bonds are qualified for an interest deduction.[37] If this qualification for deductions is not available, financial institutions may increase their bids anywhere from ten to twenty-five basis points.

Cash-flow planning is essential. Missing the spend-out requirements will result in penalties to pay or an obligation to rebate earnings on invested bond proceeds to the federal government.[38]

The school district must determine when the project will be completed.[39] If the work or acquisition is completed and if all the proceeds from the sale of bonds, except up to five percent retainage, are spent within two years, the school district may issue any amount of bonds for the project during the calendar year by electing to treat the bonds as "construction bonds." This will exempt the bond issue from the arbitrage rebate requirements of the Code.

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[35] I.R.C. § 148(f)(4)(G) (1986).
[36] *Id.* § 148(f)(2).
[37] *Id.* § 265(b). *See infra* ch. 7.
[38] *Id.* § 148(f). *See generally* F. Ballard, Jr., The ABC's of Arbitrage, American Bar Ass'n, Urban, State & Local Government Law Section (1990).
[39] *See infra* ch. 6.


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If a district uses the "construction bond" exception, cooperation between the architect and the financial consultant is critical to determine the cash flow and the construction schedule and assure compliance with the expenditure schedule required by the Code. The Code provides the following expenditure schedule for the proceeds of a "construction bond" issue: 10% or more must be spent within twelve months; 45% or more within twelve months; 75% or more within eighteen months; and all of the money (less a 5% retainage) must be spent within twenty-four months of the issuance of the bonds. With few exceptions, a 5% retainage may be deducted from these spending requirements, but the 5% retainage must be paid out at the end of thirty-six months.[40]

A project fund may also be exempt from rebate if it meets the eighteen month exception.[41] The following expenditure schedule of the proceeds must be met to qualify for this exception: 15% or more must be spent within six months; 60% or more within twelve months; and all of the money (less a 5% retainage) must be spent within eighteen months.

If a school district spends all the bond proceeds within six months after the bonds are issued, the Code provides another exception to the rebate rules.[42] Generally, bonds are sold before construction contracts are let because contractors want to know the money will be available to pay the bills when the work is done. However, with some temporary financing mechanisms, a district can issue bonds and spend all the proceeds within six months and be exempt from arbitrage rebate rules.

Reimbursement regulations also may affect planning.[43] In the past, there was little need to worry about making capital expenditures and paying out cash on a timely basis, because bonds could be issued later to reimburse the accounts from which payment was made. The Internal Revenue Service regulations now provide guidelines for the use of proceeds to reimburse amounts that have been spent for capital items (such as costs incurred to acquire, construct, or improve land, buildings and equipment) prior to the issue date of the bonds. Under the reimbursement regulations, before making an expenditure in the first instance or within sixty days after the first expenditure, a resolution must be passed which declares official intent to reimburse the fund or account with the proceeds of tax exempt bonds to be issued later. The declaration among other things, must be consistent with the school district's budgetary and financial circumstances.[44]

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[40] I.R.C. § 148(f)(4)(C) (1986).
[41] Treas. Reg. § 1.148-1(b).
[42] I.R.C. § 148(f)(4)(B)(ii) (1986).
[43] Treas. Reg. 1.103-18. *See infra* ch. 7.
[44] *Id.*

### C. How Will the Bond Issue Be Marketed?[45]

Although a financial consultant may be hired, the board and administrators should still be actively involved in this decision. Determining the maturity schedule to be used, whether the debt service levy will be constant throughout the life of the bond issue, or will be retired quickly, are administrative and board decisions. Restrictions may be established on the number of interest rates. Should rates be ascending or descending or in some fractional multiples? In addition, there should be a determination whether to include an option to call the bonds prior to maturity and, if so, at par or a premium. This can have an impact on interest cost but also will be important for future planning if the debt of the district needs to be restructured in the future or a more favorable interest climate make a refunding attractive. Normally, if there is an option at the end of nine years, the market is not affected. Refunding bonds issued at a higher interest rate may save the district substantial sums of money by remarketing at a lower interest rate than was available at the time of the building project.

### D. Should Bonds Be Registered by a Bank Registrar or by a School Official?

Federal tax law requires that all tax-exempt bonds be registered.[46] Bond registration records must be prepared and maintained by the registrar. On payment dates, interest and principal payments must be made to holders of bonds pursuant to terms of the resolution that authorized the bonds. In the past, school officers usually served as registrars. However, the school district may find it desirable to employ a bank trustee as registrar, transfer agent and paying agent in order to relieve district officers of annual tax reporting and other administrative burdens.

The "book entry" system is a relatively new concept for the registrar, the paying agent and the transfer agent functions. This system provides many advantages to the district, not the least of which is reduced administrative costs. The district does not deal with the printing, delivery and transfer of certificates, and only has to make one payment on payment dates to the agency responsible for the book entry system. One major drawback of this system is that individual bond buyers may still want a certificate in their hands or in their account.

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[45] *See generally* 64 Am. Jur. 2D *Public Securities and Obligations* §§ 218-249; PUBLIC SECURITIES ASS'N, NEW YORK, FUNDAMENTALS OF MUNICIPAL BONDS at 72-73 (4th ed. 1990).
[46] I.R.C. § 149(a) (1986); PUBLIC SECURITIES ASS'N, NEW YORK, FUNDAMENTALS OF MUNICIPAL BONDS at 26-27 (4th ed. 1990).

### E. Should Bid Security Be Required?

In some states, bid security is required when submitting a bid. If security is not required and the issue is under $500,000, generally (unless state law requires) a bid security is not necessary.

### F. How and Where Will Bids Be Received?

State law may require that the bids must be received and tabulated in a public meeting. If there is a financial consultant and state law allows it, the consultant may receive and tabulate the bids and report back to the administration and board. The board then will make the decision to sell the bonds based on this report.[47]

### G. Is It Necessary to Obtain a Rating from One of the Major Rating Agencies on the Bonds Prior to Sale?

A higher rating will ordinarily translate to lower interest cost. If the district is stable and the issue is small, buyers may buy the issue at a good rate whether or not the issue is rated. However, a district may face another problem if it previously had a rating and decides to sell bonds without a rating. The rating agencies may withdraw the rating from prior issues which will affect future sales.[48]

### H. Should There Be Bond Insurance Available?

If bond insurance is available should the district or the bidder pay the premium for it? Ultimately, the district will pay. If a district receives a low rating, it may be wise to obtain insurance to sell the bonds with an AAA rating.[49] The cost of insurance will generally be less than the uninsured interest cost due to a low rating.

### I. Is There Any Litigation Pending and What Will Its Effect Be on the Sale for the Bonds?

A large claim for damages must be disclosed to prospective purchasers because it may have an impact on the district's financial stability. Other litigation may affect the marketing of the bonds; for instance, a suit challenging the state finance laws or tax system may have an impact and must be disclosed. If a district has an election contest lawsuit pending, the district can sell the bonds with disclosure to the purchasers about the probability of success in the litigation. However, the bond issue cannot close until the litigation is settled.

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[47] Public Securities Ass'n, New York, Fundamentals of Municipal Bonds ch 4 (4th ed 1990); *see generally* 64 Am. Jur. 2D *Public Securities and Obligations* §§ 118-249.

[48] *Id.* at 43-51.

[49] *Id.* at 68-69, 140.

### J. Should Bidders Be Allowed to Bid a Discount if Permitted by State Law?

If discounts are allowed, what should the discount be? A discount is usually an advantage to the district because it allows the purchaser to price bonds to the ultimate buyer at a better price. If a discount is allowed, purchasers may give a lower interest cost because the discount will necessarily reflect the amount of commission to be paid to buy and resell the bonds at the time of sale.[50]

## VI. Bond Sale

After competing the foregoing decisions and actions, the district is ready to receive bids. What bid offers the lowest net interest rate? The ultimate decision should be based on which bid has the lowest cost over the life of the issue. If only one bid is received, should it be accepted? In most states, legally it can, however, the district should try to obtain a minimum of three or four bids. In larger issues, syndicates may form and one bid may include three or four financial organizations. If only one bid is received, the district should rely on the financial consultant and bond counsel to determine whether it is a good bid before making the award.[51]

## VII. Closing

After the sale, bond counsel proceeds immediately to verify bids, compute the tax levies, prepare the resolution issuing the bonds, prepare documents needed for the levy of the tax to pay principal and interest and for appointment of the registrar and paying agent. Final certificates must be executed by the district, registrar and purchaser to complete delivery of the bonds. If bond insurance is being used, the bond insurance company must be contacted to ensure that necessary certifications and proper wording are included in the bond documents.

Prior to closing, bond counsel will review all bond documents and certificates including those regarding the tax exempt status of the bonds, check the purchaser's certificate, and prepare the legal opinion. District officials will need to be available to sign various certificates. The bond counsel opinion assures the ultimate purchaser that the district has com-

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[50] *Id.* at 76-81, 171-86.
[51] *Id.*

plied with all legal steps, that the bonds were sold and issued in compliance with state law, and that the interest on the bonds is tax exempt from federal taxation.

Finally, the money is deposited in the district's account and the bonds are issued and delivered to the purchaser. Typically, all documents are furnished prior to the day of closing and arrangements are made to transfer the money to the district's account. On the closing day, bond counsel confirms that the facts contained in the certifications have not changed and that there is no litigation pending. When confirmation is complete, the bonds are released to the purchaser upon receipt of the funds to the district's account by check or wire transfer.

## VIII. Tax Information Reporting Requirements

To maintain the tax-exempt status of bonds, an information return must be filed with the Internal Revenue Service not later than the fifteenth day of the second calendar month after the close of the calendar quarter in which the bonds are issued.[52] For school districts, Form 8038-G must be filed within this time limit for bond issues of $100,000 or more. Form 8038-GC (a consolidated information return) must be filed for all bond issues (including lease-purchase agreements which are treated as tax exempt) and short-term cash borrowings at the bank where the amount is less than $100,000. Form 8038-GC must be filed on an annual basis by February 15 of the calendar year following the calendar year in which a small issue was issued.[53] State law may require additional reporting.

## IX. Money Management During the Construction Period

In making investments, the school district must be aware that the Internal Revenue Code requires issuers of tax-exempt bonds to rebate to the federal government the earnings on investments in excess of the yield on the bonds, unless the bond issue satisfies one of the exceptions to the rebate rules. Compliance with the rebate rules is costly and administratively burdensome. Thus, it is important in planning the bond issue that the bond issue be structured to satisfy rebate rules by either taking advantage of one of the following exceptions, or otherwise assuring compliance:[54]

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[52] I.R.C. § 149(e) (1986)
[53] *Id.*
[54] *Id.* § 149(f)

**A. The district can plan to meet the six-month expenditure exception.**[55]

**B. The district may qualify for the $5,000,000 small-issue exception.**[56]

**C. The district may qualify for the eighteen-month or two-year expenditure exception for construction bonds.**[57]

After proceeds are received by the district, the financial consultant assists the district with investing bond proceeds in accordance with terms of the bond resolution and tax exemption certificate to comply with arbitrage requirements. Earnings on proceeds can be used for debt service purposes, costs of issuance, and, in some states, to pay the cost of additional work within the purposes authorized by the bond proposition which was approved by the voters. Each year the district must monitor its expenditures of bond proceeds to ensure compliance with federal tax requirements. Thus, bond counsel and the financial consultant must work carefully with the school district in planning and administering the bond issue to avoid the penalties built into the federal tax law.

After making certain that all federal tax requirements are met, the bond counsel and financial consultants should develop and oversee the investment of bond proceeds during the implementation of the project. Sound investment policies must be developed to assure that investments comply with state laws and that investments are safely held pursuant to custodial and collateralization guidelines. Investments should be for a term that assures safety and liquidity so that funds are available when needed. Moneys should not be commingled with other district funds and investments should be made pursuant to policy that requires and specifies the persons who are authorized to make the investments. There should be appropriate internal control mechanisms and audit standards for all financial operations.[58]

A common goal of cash managers is to improve the quality and efficiency of investment activity.[59] The SEC recently advised that "inves-

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[55] *Id.* § 148(f)(4)(B)(ii).
[56] *Id.* § 149(f).
[57] *Id.* § 148(f)(4)(C).
[58] *Newsletter of the Government Finance Officers Association (GFOA), Chicago, Illinois,* PUB. INVESTOR, vol. 10, No. 11 (Nov. 1, 1981). *See also* J. FLYNN, THE ART OF INVESTING SCHOOL DISTRICT FUNDS: RULES OF THE GAME, ASS'N OF SCH. BUS. OFFICIALS INT'L (1990).
[59] *Newsletter of the Government Finance Officers Association (GFOA), Chicago, Illinois,* PUB. INVESTORS, vol. 10, No. 11 (Nov. 1, 1981).


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tors need a clear understanding of the terms and the particular risks arising from the nature of the products."[90] Identifying the risks involved in the investment process and designing controls to prevent or limit those risks are factors which should enhance the investment process.

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[90] *See infra* ch. 8.

# PLANNING AND CONSTRUCTING SCHOOL FACILITIES

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## I. Introduction

Constructing school facilities requires a multitude of considerations: long-term planning and involvement of stakeholders, availability of financial resources, legal and financial counsel, and contracting with architects and contractors. Assuming a life expectancy of sixty to seventy years for a well-constructed facility, the approximately three to four years of planning and construction represents a relatively short but critical initial phase in its overall life line.

At first glance this chapter appears to suggest that planning for and constructing school facilities is a relatively simple or easy task. In fact, planning can be a long series of complicated tasks, filled with emotion, disagreements, learning, negotiations, displays of incompetence, and conflicting opinions of both experts and rival groups. The challenge for those responsible for the planning process is to deal effectively with these dynamics. To anticipate and gather necessary information and to engender momentum for consensus and team building. The end product, a functional building can serve as the starting point for its new occupants to begin to build on the dynamics as established in the planning phase.

This chapter provides an overview of the processes necessary to construct a public building. It urges that form should follow function and that districts must develop clear understandings and definitions of function before they can apply these to specific forms, in this case buildings. Public service, learning, and teaching have been impacted by new methodologies, the use of technology, value changes in society, changes in values for the individual, and in actual learning or service outcomes. The one-room schoolhouse mentality translated to many one-room schoolhouses within a larger facility, is slowly giving way to broader, more integrative approaches to education. These include: spaces for learning teams, small group investigation, interaction with the surrounding community, and flexible space allocation. Recent changes in the delivery of instruction and services have impacted facility design. These pose formidable challenges to public officials and architects charged with providing facilities which meet these rapidly changing functions.

This chapter outlines a suggested sequence of processes and events helpful in the initial critical three- to four-year planning phase in the life line of an educational facility.

## II. Long-Range Planning

Planning requires at least a one-year lead time to obtain the necessary information upon which to make decisions. A published plan, collaboratively developed, can prove invaluable to those within the organization and to the public it serves. The components of a long-range facility plan for a school district include the following:

### A. Demographics

Demographic information must be utilized during the planning processes. Decisions to remodel or to construct new buildings must be based upon clear data which reflect historical trends and logical projections.

Obtain historical data on enrollment, by attendance area, and by grade level.

Outline trends in the enrollment history and link those trends to community development dynamics.

Obtain planned land use maps for the area the district serves with projected student yields based upon prior land use studies. Display enrollment growth patterns based upon historical information. Growth curves should display the impact of initial development, peak yields, decline, and finally stabilization. From this short- and long-term student yields may be determined.

Create a liaison with municipal organizations to obtain development plans for the areas they serve. Determine positive or negative impacts from their information.

### B. Organizational Structure

If possible the organization of the grade levels served should be philosophically based rather than based upon the availability of facilities. Opportunities to refine the philosophy for the organization structure are enhanced during planning for remodeling or when considering new facilities.

If enough latitude exists to place students in structures according to an educational philosophy, then there is an opportunity to proceed in a different direction. Create a philosophical base for the grade level distribution for students, i.e., K-6, 7-8, 9-12, or other combinations. If the efficient use of existing buildings dictates the existing organizational structure, then the philosophy should possibly reflect that requirement.

Determine other potential alignments, such as multiage or multigrade level groupings, their degree of efficiency and their relationship to the district's educational philosophy concerning learning.

## C. Educational Specifications

Group consensus techniques are important in this phase of planning. Participants should be provided structured opportunities to quantify value statements and place those statements in order of priority. This phase involves reviewing the available literature, as well as visiting schools that appear to reflect a similar philosophy. Obtaining copies of these statements from others who have written these key statements may facilitate the process.

Write a philosophy statement and guiding principles for each cluster of grade levels in the organizational structure. Groups of educators, students and parents can prove invaluable in this process. A wealth of literature exists concerning learning environments and suggested space arrangements. Space guidelines have been published by the Council of Educational Facility Planners[1] and could provide a valuable resource in this phase.

Statements of philosophy and guiding principles create the foundation for planning and designing school facilities.

Create an outline for each service area or learning space which includes the following:

- Program, curricular or service impact–define the curriculum/ instructional philosophy for that particular function;
- Square footage
- Location
- Learning/service activities
- Learning aids and equipment
- Storage and other needs.

Create a grid for all spaces.[2] Re-examine these for redundancy, potential efficiencies, needs for reduction or expansion.

## D. Finance Options

Once an outline of facility needs has been completed for short- and long-term planning, the next step is to determine the availability and

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[1] Guide for Planning Educational Facilities, The Council of Educational Facility Planners, Int'l (1991).

[2] Profile Space Guidelines, *The Educational Facility Planner*, Council of Educational Facility Planners, Int'l, vol. 27, No. 4, (July-Aug. 1989). *See also Guide for Planning New and Improved School Facilities in Minnesota*, State of Minn. Dep't of Educ. Management Effectiveness Div., July 1988.

sources for funding. An understanding of state law as it relates to funding capital projects is an obvious necessity. A public referendum may be required and in most states a 50% plurality is required. In a few states, including Iowa, a referendum requires 60% for passage.

A financial consultant may be required at this point to offer assistance when considering options to fund capital projects. Optional levies are available in some states and may be Board approved or a combination of Board and voter approved. Long-range planning must include an assessment of the timing and capacity of issues.

The following considerations in funding projects should be included in a long-range facility plan. An overview of needs, costs and order of priority is required even though agreement on funding has not been reached. There must be an acknowledgment that each capital project requires the approval of policymakers and perhaps voters prior to moving forward.

- Outline a complete list of major capital projects, their estimated cost and order of priority.
- Outline projects that should be completed within existing levies targeted for capital projects.
- Determine which projects require funding to the degree that it must be obtained through a referendum. If the project or projects must have the agreement of the district's stakeholders and policymakers. It is appropriate to include projects in a long-range facility plan that has not yet reached the consensus stage for funding.

## E. School Buildings and Sites

This section in a long-range facility plan can serve the district in many positive ways. Professionally drawn floor and site plans can be utilized on a daily operation basis for work orders, or for long-range planning when considering renovation or additions to facilities. The initial effort and expense for an architect to place building and site plans on computer software such as AutoCad pays off in planning and the drawings can be easily updated. Master site planning can assist parent organizations or the district when creating recreation spaces or for installing playground equipment. Floor plans can also serve as signage in the facility for safety drills and for directional signs.

Annual buildings and grounds surveys, coupled with demographic information and planning for enrollment changes, are critical elements in maintaining and improving the life line of a facility.

## F. Support Facilities and Sites

Districts operate through a range of support services: maintenance, transportation, instructional and curriculum services, staff development,

employee recruitment, business and administration. Again, an outline of the operating philosophies of these services is necessary. Since they function interdependently, coordination is necessary.

School district board offices or administrative offices may be transformed to people development or learning centers. The renovation and construction for these facilities requires the same collaborative, deliberative effort that is outlined above for a school facility.

## G. Site Acquisition

This section in a long-range facility plan directly relates to demographics. Land use guidelines promulgated for the areas served by the district are key documents. Decisions on where to place new facilities depend on information about: 1) street or highway access, 2) direct access of the site to housing developments, 3) the degree of safety of traffic flow, 4) proximity to commercial development, 5) size of parcel required (need for recreation space, practice fields, parking, outdoor study areas, etc.), and 6) cost or accessibility of land.

## H. Community Use of Facilities

An increasingly important educational philosophy is the concept of life-long learning. If the district is serving a community of learners and if the district is adopting a philosophy of K-12 learners interacting with the community, then the design of the facility should say "welcome." Recent publications indicate a desire to depart from an "institutional" look for schools and move toward village or community facilities which are flexible and serve multiple functions.

Increasingly there is dialogue concerning cooperation between public entities such as schools and cities. Planning for sites and facilities in concert with other public entities may serve the taxpayer more efficiently and convey a strong message of sensitivity to the needs of citizens. If a philosophy exists that all taxes, whether targeted for schools, counties or municipalities, should provide services and it does not matter as much which entity provides the services, then efficiency and effectiveness have a better forum for discussion. The public is increasingly critical of the manner in which public entities spend their money. This attitude creates an opportunity to demonstrate collaboratively in planning programs and services within facilities that serve the same client.

## I. Maintenance and Repairs

Information in this section enhances the ability to plan for preventive and corrective maintenance. This section of a long-range facility plan should include information from the most recent survey of build-

ings and maintenance needs. Roof plans, their condition and replacement schedule, boiler condition status reports, paint schedules and mechanical and electrical condition reports are essential pieces of information in the life line of a facility. Efficient mechanical and electrical systems in a facility directly impact the operating cost for that facility.

### J. Governmental Requirements

This section in a published long-range facility plan outlines federal, city and state requirements. The list is necessary when considering whether to upgrade a facility to meet new requirements and for other long-range planning. The following topics receive extensive attention and detail in governmental publications:

- Safety: asbestos, lead, radon;
- Fire inspections: exit lights, emergency lighting, signage, alarms, etc.;
- ADA requirements, including handicapped accessibility;
- City code requirements, including approvals necessary prior to and during construction;[1] and
- Parking requirements and screening for parking.

## III. Planning for the Construction of a Facility

Assuming that a long-range plan is in place and requires construction of a facility which requires a public referendum, the district is ready to move forward with specific plans for the needed facility. The following sequence of events has proven to be successful. While the chronology of events may vary depending upon unique situations, it is offered as a guideline for planning. Floor plans and elevations that have been developed prior to a referendum probably solicit votes on the design rather than the need and concept. If the situation allows, the district should be sure voters have a clear understanding of the need, the solution to the need and a firm cost analysis and debt service schedule well before the date for voting. This requires extensive information gathering by district personnel and from consultants. The following tasks must be completed:

- Review the outline of the philosophy and guiding principles for the facility.
- Complete the educational specifications for the facility with collaboration from teaching and other administrative personnel.
- Review any legal sections, including the request for proposal (RFP's) with the district's legal counsel.

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[1] *24th Annual M & O Cost Study*, Am. Sch. & U., April 1995.

- Develop a RFP for architectural services that includes: 1) design expectations, 2) scope of services, 3) owner's responsibilities, 4) proposal content, 5) proposal submission, 6) reserved rights, 7) schedule, 8) selection criteria, and 9) selection process. Attached to the RFP should be a copy of the philosophy and guiding principles statements.
- Develop a RFP for financial services that includes: 1) purpose, 2) background of the district, 3) direction and management of the district, 4) authorized and issued bonds and debt service rates, 5) proposed bond election, 6) scope of services, 7) requirements, 8) fees, 9) terms and conditions, and 10) a timetable.
- Establish firm cost estimates for the project, parameters for funding and a debt service schedule most suitable to the funding structure for the district.
- Present facts and information to community groups and to internal employee and parent groups.
- Appoint a marketing committee for the referendum at least six months prior to the possible election.
- Obtain endorsements from key community groups for the referendum.
- Receive petitions from the marketing committee to hold the election.
- Interview and appoint an architectural firm with Board approval of the contract.
- Interview and appoint a financial consulting firm with Board approval of the contract.
- Hold the election for passage of the referendum.
- Begin to translate the educational specifications with the assistance of the architectural firm.
- Proceed with the design development and construction documents with the architectural firm, always checking back through the charrette process to assure that form will follow function.
- Obtain Board approval as necessary for each of the document phases: 1) schematic design, 2) design development and 3) construction documents.
- Place the construction documents out for bid.
- Receive bids, evaluate and recommend the low bid for Board approval of a contract between the owner and contractor.

## IV. Construction Phase

The size and complexity of the project dictates the degree of construction management required by the school district (owner). Larger

projects may require that the owner provide daily oversight through contracted services. If management oversight services are required, a job description and a line of authority must be established. The owner's point person and/or hired construction project manager must have a thorough understanding of the construction documents and all specifications. All construction must conform to the detailed specifications and any deviation must be approved by the architect and by the owner. The value of daily site observation manifests itself not only in maintaining the planned construction schedule, but in identifying nonconforming construction at its initial stages.

The architect and general contractor should provide the names and phone numbers of all subcontractors to the owner. The owner should obtain a submittal schedule when the project begins. The owner can assist in maintaining the construction schedule by referring to the submittal schedule at each construction progress meeting.

The owner must establish a point person to receive, consider and coordinate all information from the architect and contractor. All change orders and payments should flow through this one person. A clear outline of the approval process should be distributed to other district administrative personnel if they occupy the site. Efficient control of costs cannot be maintained if other owner personnel enter the process and initiate change orders or impact the progress of construction without appropriate consultation and authorization. There must be an understanding of the approval process including relationships between the general contractor, their subcontractors, the project architect and their engineers, and the district's point person.

Authorized signatures must be obtained from each key individual on the initial request for proposal (RFP) all the way to the recommendation for, and the acceptance of, the change order. The Board of Education ultimately must approve all changes to contracts. Experience has shown that poorly documented change orders, or work performed without approved change orders leads to legal difficulty, deteriorating relationships with the contractor, architect and others, and potentially to lawsuits.

There are several extremely critical phases during construction. These include: 1) rough and finish grading, 2) underground plumbing, electrical, utility and concrete work, 3) electrical and plumbing outlets placed just prior to pouring concrete floors, 4) plumbing and electrical outlets in framing (compare to finished which will include counters, shelving, cabinets, etc.), 5) infrastructure wiring, 6) roofing, particularly slopes, drains and seams, 7) window installation, 8) insulation and sealant, 9) finish work including flooring, painting, millwork, sound systems, cabinets, shelving, restrooms, etc.

The owner's point person must attend all construction progress meetings and continually ask about the status of preparation for the next phase of construction. The ordering of materials and the organization and planning for subcontractors is crucial to maintaining steady progress on the project schedule. The importance of referring to the submittal schedule increases as the project nears completion. The ordering of millwork, the installation of equipment and the myriad of small items is crucial to meeting completion deadlines. Delays in ordering the relatively minor but extremely critical pieces of equipment such as exhaust hoods, cabinetry, fire alarm equipment, restroom equipment, etc., can result in the prolonged postponement of occupancy.

The punch list (faulty construction items) must be thorough and detailed. If the district is authorized to hold five percent of the contract until all work is completed, then that amount should be retained until the owner is fully satisfied the project is complete, all manuals and warrantees have been submitted and that all tax rebate forms have been forwarded. All inspections, including the fire marshall, building inspector, elevator inspector, etc., must be completed and punch list items as identified by those individuals be addressed quickly.

A final examination of the facility, including the balancing of the air handling system and temperature control system is a must. After the completion of all punch list items and after the close-out documents have been completed, the point person may then recommend final payment to the Board for approval.

At least six months prior to anticipated occupancy all required furnishings should be ordered. The architectural firm may be called upon to assist in developing packages of items for bid, color coordination, and specifications for assembly. The planning for the purchase of furnishings can be enhanced with the input of staff and students. Such participation may strengthen the ownership felt by the occupants of their building.

## V. Occupancy

The final and most satisfying phase of construction is the time to move into the new facility. Prior planning for the move is essential. This includes the human dimension as well as the equipment and operational detail. Employees transferring from existing facilities to a new facility undergo the typical stresses associated with significant change including a new and unknown environment as well as new co-workers and changed work dynamics. The appointment of a transition team may assist in planning the move and all of the details associated with the new operation.

Items that should be addressed prior to the move include: 1) phone lines and number changes, 2) the address and stationary changes, 3) the

receipt and distribution of mail, 4) the keying schedule and the distribution of keys, 5) the organization and responsibility for vending machines and coffee, 6) signage, 7) temperature settings, 8) cleaning schedules, 9) security of the building, including opening and closing responsibilities, and finally 10) an open house to celebrate the completion of the effort and the beginning of a new service facility.

Finally with the building now fully operational, a preventive maintenance program must be implemented and operational aspects of the facility monitored.

## VI. Conclusion

The complicated and time consuming tasks and events from the earliest planning phases to occupancy, require the best collective expertise and wisdom the district possesses. The form of the building, when designed and built according to the functions within, can be most dynamic and rewarding. Every phase of planning requires coordination of numerous groups, including legal, financial, architectural, and engineering counsel, in a complex series of tasks.

The planning phase for general district site and facility needs should be based on an underlying written long-range plan which includes the following: 1) demographics, a historical perspective as well as projections for the district , 2) a grade level organizational structure and its rationale, 3) educational specifications, including philosophy statements and guiding principles, 4) finance options, 5) detailed descriptions of existing school buildings and sites, 6) detailed descriptions of support facilities and sites, 7) a plan for site acquisition or disposal, 8) a plan for community use of the facilities, 9) detailed condition descriptions and life expectancies for all major maintenance items such as roofs, boilers, and other systems, and 10) a list of governmental requirements to include in any new or remodeling project.

The planning phase for a relatively large construction project will be based on and logically reference the long-range facility plan. The charrette process utilized with district representatives and architects serves to define function and its rationale prior to determining the form for the building.

The construction phase requires the owner's point person manage the project in the interest of the district. The point person must understand all construction documents and actively monitor progress at the site. The point person assists in keeping the project on schedule by appropriately utilizing construction progress meetings, submittal schedules, change orders, and information concerning subcontractors.

The last critical steps prior to occupancy are time consuming and require careful planning. The final ordering of equipment to be installed by the general contractor as well as the installation of furnishings by the owner must be well coordinated to allow for a smooth entry by the occupants.

Planning for the transition of people to a new facility is also important. How people can best accommodate the transition to the new building and to the changes in philosophy and method pose ongoing challenges if district goals are to be met.

However, the value of the endeavor is obvious if one considers the benefits to students' education and the community over the sixty- to seventy-year life line of the facility. The planning prior to construction, careful monitoring during construction, and attention to occupancy requires substantial effort and extensive expertise.

# TYPICAL PROBLEMS IN SCHOOL BUILDING PROGRAMS, AN ARCHITECT'S PERSPECTIVE

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## I. Introduction

There have been thousands of school construction programs. Some finish on time, within budget, and meet or exceed their district's objectives. Others encounter serious problems–some so serious that administrative staff lose their jobs, voters lose confidence, and the district suffers long-term repercussions. Many of these problems are repeated in districts across the country. This paper summarizes ten of the most common and serious problems encountered in building programs and offers guidelines for avoiding each of them.

## II. Failure to Plan

Goals result from thorough planning. Planning is the essential first phase in goal setting. While a district should regularly monitor its existing programs, demographics, and resources, planning a building program requires a systematic evaluation of specific needs for the appropriate learning environment in the future. The basic elements of this process include a detailed evaluation of existing conditions, the preparation of a clear statement of the additional spaces and/or renovations of existing facilities that are needed, an analysis of the alternatives available, and preparation of a plan that addresses all of the high priority needs.

In some cases, careful planning may reduce the need for construction. For example, brick and mortar solutions may be avoided by scheduling or other lower cost solutions identified in the planning process. For example, one institution avoided most of a proposed building program by rescheduling combined with improved departmental sharing of resources. Another avoided new construction by identifying and converting underutilized spaces within the district's schools. School building programs should be driven by curriculum, teaching, and learning needs. Not every demographic shift needs a construction response.

Often, however, brick and mortar solutions are required. Many districts under budgetary pressure have deferred maintenance needs for years.

Others are responding to evolving educational requirements. Even districts with significant declines in student population face space shortages. Computer labs and other program changes require more rooms to serve the same number of children. Careful planning can minimize the need for building but eventually all districts have construction needs. When the need for construction is identified by and justified through the planning process, planning prioritizes needs, options in terms of effectiveness to meet the needs, and a clear, staged master plan for implementation.

## III. Unclear and/or Unrealistic Goals

A building program is a complex but manageable task. The first step in effective management, requires a clear statement of the program objectives. Many districts ignore this step. Others fail to apply realism to their goal setting. Serious problems for a building program begin with goals that cannot be met: a budget that is too low, a schedule that is too short, or an educational outcome that cannot be met.

An unrealistic initial budget can haunt an entire building program. The first, publicly discussed, budget estimate has a life of its own. It creates a target everyone remembers and the standard for evaluating how well the program is managed. No district should ever publicly announce a budget target that is not based upon a clear outline of all goals to be accomplished within the building program. Budgets prepared at the beginning of a project can be accurate for a building program, but this only happens when preceded by careful planning and meticulous budget preparation processes.

The same care is needed in setting the other basic program goals. A frequent error is to expect too much from a renovation program. "Parity" between older and newer facilities is often not attainable even after spending amounts that approach replacement cost. In some instances older facilities cannot be renovated to support modern teaching methodologies, new technology, or even current life safety requirements. The resultant compromises may point to replacement rather than renovation as the better, though harder to sell, course of action.

Goal setting, of course, should cover every other aspect of the program–from a program's ability to respond to future growth and change to a realistic target date for completion. These goals cannot be set arbitrarily but must evolve logically out of a careful master planning effort.

## IV. Inadequate Client Leadership

Selection of a strong, professional team does not relieve the district from its role as the team leader. As any experienced design professional

will quote, "You cannot create a good building without a good client."

There are some tasks that cannot be delegated. The district must–at a minimum–provide at least the following:

- Selection of a qualified professional team and structuring of the services necessary to plan and carry out the program.
- Setting the overall goals and providing the district's perspective during the planning and design process.
- Selecting the program and design solutions–from the competing alternatives–that best satisfy the district's objectives.
- Resolving differences and problems between team members.
- Administering the several contracts and managing the team's performance on behalf of the district.
- Leading the relationship between the project team and the public.

This last task–public presentation–is an essential part of the district's leadership obligation as well as the design team's service. The core of an effective justification of need for a building program is an effective planning process. The school district leadership must make sure that the results of this planning process are clear, defensible, and effectively presented.

All school spending plans face potential opposition. The easiest ways to attack a proposed building program include pointing out lower-cost alternatives that were overlooked, highlighting shortcomings in the current management of the district's facilities, and identifying questions about the accuracy of the budgeting and planning. If opponents can make a credible case of potential waste, lax management, or future cost overruns, a bond issue may be in trouble. If a bond issue fails initially, passage on a second round is often more difficult. The result is often a reduced and compromised program in the future. Again, the antidote is a thorough planning phase, properly reviewed and presented.

## V. Selecting the Wrong Professional Team for the Wrong Reasons

Few districts can analyze their needs and present a realistic plan without some technical assistance. This includes the professional advice from architects and engineers as well as legal and financial advisers. There are many architectural and engineering firms with the expertise to provide the planning, design and project management services required for a successful program. Legal and financial counsel provide guidance to ensure compliance with the expanding regulatory environment of public funding.

Identification of qualified consultants able to work as a team with district personnel is a key step that begins with a good selection process.

The first step in this process is a set of selection criteria which evaluate the candidates against the district's major service needs. No two lists of selection criteria used in identifying the necessary professional consultants are identical, but typical issues include the following:

- The firm's and the proposed project team's demonstrated experience in dealing with comparable issues of program, site, renovation, budget, etc.
- The quality and consistency of the references from other clients.
- The team's track record for bringing in projects on schedule and within budget as confirmed by past clients.
- The firm's interest in the project and willingness to commit its best resources to the program.
- The quality of the team's engineering capabilities–in particular mechanical, electrical, plumbing, and fire protection engineering. (It is not unusual for the district to participate in the separate selection of each design discipline.)
- The special skills–design creativity, ability to help present the program to the community, sensitivity to particular program issues, etc.–that the team will bring to the project.

The selection process should be based on a list of criteria and a process which evaluate the firm against the district's most important needs. This is usually accomplished as follows:

- The district obtains lists of potentially qualified firms from other districts, its own past experience, and other sources.
- A request for qualifications is advertised and is also sent directly to the firms identified.
- The qualifications (firm experience, individual team experience, special skills, etc.) are evaluated and a short list (three to eight firms) is selected for interview.
- Each firm is interviewed and the two or three preferred firms are asked for a proposal outlining a scope of services and fees.
- Following evaluation of the proposals, the fees and scope of work are negotiated with the preferred firm.

The lowest fee proposal, renderings or cost estimates of theoretical solutions, as well as other free work, are foolish bases for selection. Fees can be negotiated, in most cases, to acceptable levels. Free up-front work not done after working with the district is rarely of any lasting value. A successful school design comes from a careful process carried out by a design team that can bring the design and management skill to bear over the several years that it takes to implement a building program.

## VI. Ineffective Management

Although most districts recognize their management responsibilities, several common errors in management compound the problems encountered in construction programs. In some cases the district fails to organize clear decision-making procedures. In others, micromanagement or poor interpersonal relationships interfere with the coherent work process and team effort necessary for a successful building program.

There are several ways to organize management responsibilities for a building program. In some cases, the district administrative staff provides the day-to-day leadership and the Board reviews and approves the major policy issues (budget, team selection, major design choices, etc.). In others, the Administration and Board assume leadership and are supplemented by a Building Committee and/or additional staff with the skills to help manage the program. In the latter, a Building Committee typically includes a design professional, an attorney with construction experience, and a builder among its members.

Whether the administrative staff or a Committee approach is used, one individual should have the authority to provide day-to-day decision making within the framework of the project plan. This individual should have the ability to build a consensus among the committee and, when necessary, to make the decisions needed to advance the project even if a consensus does not exist. Clear allocation of responsibilities will go a long way toward enhancing program management.

## VII. Placing Too Low a Priority on Quality

The quality of a school building has a direct impact on the people who use it. A school building is a long-term–often fifty years or more–community asset. It provides the environment for learning. A well-planned and maintained school can facilitate the educational program. A badly planned or maintained building can create barriers.

No district starts out with the objective of building a low quality school but poor quality may result. The most common culprits include an overemphasis on cost, an initial budget that is too low, planning only for the short term, failure to build in the capacity to grow or change in the future, and overreliance on outdated and unimaginative models.

One of the primary services the design team can provide to the district is a clear understanding of the trade-offs between cost and quality. The team must ensure that all participants in the planning process understand the differences between first cost vs. life cycle cost, and short-term vs. long-term needs. In addition, the design team should challenge traditional school building models and present the district with alternatives which reflect the district's specific needs and academic objectives.

## VIII. Poor Cost Management

Most building programs are dominated by a focus on first cost. This overemphasis on first cost often stems from a fear of cost overruns. Construction costs–and even life cycle costs–can be managed. There is no reason why a school program should not finish within budget, but this can only be accomplished with the help of an effective cost management process.

An experienced design team can help a district set a realistic budget that properly reflects the district's goals, program, and master plan. Once the budget is set, the design team should present the options and their cost implications at each stage of the process. There are thousands of planning and design choices made during each phase of a building program. In a well-structured design process, the most important of the choices–with their costs and benefits–should be presented to the district's decision makers.

## IX. Failure to Plan for Maintenance

No matter how well built the facilities, they will not last unless they are maintained. An overemphasis on initial construction cost (vs. life cycle cost) or poor choices in the initial planning can accelerate the need for a maintenance program. All building systems from roofs to boilers must be maintained. When properly maintained, their life span can often be extended indefinitely. When districts fail to plan for maintenance or balance their budgets by deferring essential repairs and preventive measures, they are increasing a long-term liability and cost. Districts across the country continue to pay a high price for this short-term thinking.

The design team can help a district plan for and structure a maintenance program which will minimize life cycle costs. No one, however, can eliminate the need for some ongoing annual capital and maintenance expenditures. The design team should not try to minimize a district's life cycle costs by overreliance on technology. Many districts do not have the maintenance and operations staff to maintain some of these more sophisticated systems. Sometimes simpler is better.

## X. A Drawn-Out or Discontinuous Schedule

The district should not ignore the importance of momentum and continuity. A project that proceeds in a steady, orderly fashion from planning through implementation is far easier to manage. Not only is a longer

process often more expensive, it can also lead to other problems. When a project stops and starts, or is stretched too far, decision making loses continuity. Key district leadership or design team members will be turned over and the rationale for decisions will be obscured. Moreover, since even a well-run program can extend over four or five years, key team members can simply become exhausted by the process. Once a district initiates a program, it should be committed to seeing it through as quickly as possible, while the understanding of the need is clear and the team is fresh.

## XI. Failure to Match the Program to the Construction Industry

The strong client and an experienced design team are only two thirds of the core leadership of a building program. The third part is the construction manager. While selection of this team member is usually constrained by public bidding laws, it is essential a district seek out the best construction resources available–both at the management level and at the subcontractor level.

In some districts, the district itself brings in the management resources–via a professional construction management service, additions to its own staff or supplemental services from the design team. In others, there is an intense, proactive effort to attract bidder interest from construction companies with proven track records on comparable projects. What does not work is a passive reliance on advertising and word of mouth to attract the key construction resources.

The design team can help attract the right builders, by investigating the local construction industry, contacting the preferred bidders, and designing the project to fit what local construction resources do best. A poorly planned building program can be packaged in a way that discourages local subcontractors because it is too big, has too short a schedule, requires too much sophistication, or has too onerous contract requirements. These errors can lead to higher prices or the wrong bidders.

With a good construction team, even a difficult project can run smoothly. One bad major subcontractor can make the whole process difficult.

All ten of these problems can be avoided. In fact, many school districts initiate high quality building programs which finish on time and within budget, and which enjoy broad public support. All building programs–even the most successful–face some problems. A well-run program will surmount these challenges. The difference between successful

programs and the ones which encounter severe problems typically does not depend on the wealth of the district. The difference is sound planning and effective management.

# DEVELOPMENT AND IMPLEMENTATION OF THE FINANCING PLAN

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## I. Role of Financial Adviser

The financial adviser's role in the planning and implementation of a school facilities project focuses on the development and successful execution of the financing plan to provide funding for the school project. The financial adviser works closely with the project architect and district bond counsel to ensure that adequate funding is available when needed to finance project costs. This article reviews the considerations which influence the development of the financing plan, and outlines the process for execution of the debt issuance and delivery of funds.

## II. Development of Financing Plan

School district interests are best served with early involvement of the financial adviser. As the first step in development of a financing plan for new facilities the financial adviser will analyze the school district's financial position, trend of operations, and economic factors impacting ability to pay debt. The existing debt structure would be evaluated for opportunities to realize debt service savings through the refinancing or refunding of existing debt. Based on a review of statutory authority for issuance of school district debt and an analysis of school district resources, the financial adviser identifies alternative debt structures, evaluates the benefits and costs associated with each alternative and guides school district officials through the development of a financing plan consistent with local ability to pay and sound planning for the long-term needs for school facilities.

## III. Statutory Considerations

Statutory considerations refer to a variety of legal and procedural issues that are mandated by state law. The particular statutory authority

establishes constraints on the choice and financial feasibility of funding options. Typical constraints imposed by state law include the need for voter authorization to issue debt, particularly debt secured by an irrevocable pledge of property taxes, possible limitations on the amount of debt which may be issued by a school district, the term of that debt and method for payment of principal and interest. States also have varied requirements and limitations on the use of competitive versus negotiated sales to fix the interest costs on debt issues and procedures for public notification of the financial impact of a proposed debt issuance. Statutory considerations thus define the framework for evaluation of alternative forms of security and debt structure.

## IV. Types of Security

In financing school projects, there are several forms of security that a school district issuer can offer as security to an investor to assure repayment of a loan, and each type of security is differentiated in the credit markets. Different borrowing costs for the issuer result from the security structure as the market differentiates between the risk of one type of security from another.

Although borrowing costs are important in determining the type of security an issuer pledges for repayment of the debt, borrowing costs are not the only criteria which issuers use in determining the security structure. Other factors including ownership of the facility, the need to have voter approval, certain legal debt issuance limits, planned use of private vendor service contracts in future operations, possible joint ownership of the facility, and the possible opportunity to reduce construction costs are some of the other reasons issuers will pledge one type of security over another.

There are three basic security structures that are commonly used as security or source of repayment. These structures include general obligation, lease revenue or lease rental, and subject to annual appropriation. A brief explanation of each structure follows.

### A. General Obligation

The general obligation security pledge is the most commonly used and strongest security pledge in the municipal bond market. Using the general obligation security, the issuer pledges its full faith and taxing power toward repayment of the debt. Therefore, if the issuer does not have other revenues on hand to pay the debt service on the borrowing, it pledges it will use any other unrestricted revenues and raise taxes in order to make the debt service payment. With this type of security, an is-

suer normally expects to pay the lowest possible borrowing costs since the security structure is well understood by the capital markets and the source of repayment is virtually unlimited.

### B. Lease Revenue/Lease Rental

The lease revenue security pledge is the second favored form of security. Using this form of security, a certain revenue stream is pledged as repayment of the debt. The revenues pledged toward repayment of the debt are the only form of revenue available for debt repayment. Typically, this form of security pledge is used where an issuer raises the capital to build and own the facility and the facility is in turn leased to another entity. The payments made by the lessee in the form of rent are at least equal to the annual debt service payments on the borrowing. Using this type of security structure, an issuer normally pays a higher rate of interest on this debt as compared with the general obligation security since the source of repayment for the lease structure is more narrowly defined and often limited to actual annual debt service.

### C. Lease Subject to Annual Appropriation

The borrowing whose repayment is subject to annual appropriation is typically seen as the least secure method of financing of the three options. As the name implies, the security of the debt is the annual appropriation of the governing body and the holder of the debt also receives an interest in the asset being financed. Although in most instances the appropriation is passed regularly and on a timely basis, there have been times when the borrowing has suffered a default and the investor is left with trying to obtain the fair market value of the asset which may or may not be equal to the initial investment. Under the lease subject to annual appropriation security structure, the issuer normally pays the highest rate of interest compared with the other two structures since the source of repayment can be reduced or terminated.

## V. Debt Structure

In addition to determining the form of security, debt structure alternatives related to the method for payment of interest and the payment of principal must be determined. The first and most common type of bond issue is the current interest bond, where interest is paid semiannually to the holders of the debt and principal is repaid annually over a fixed time period, with multiple maturities, called serial bonds. The second type, the capital appreciation or zero coupon bond, is where interest accrues and is compounded semiannually until maturity. At maturity, the holder of the debt is paid back both principal and accrued interest.

Normally, issuers issue current interest serial bonds as they can plan for the retirement of the new debt service and have no reason to defer the repayment of interest. In less frequent situations, issuers might need or have a reason to postpone the repayment of interest. In such a situation, capital appreciation bonds are used to relieve the issuer from the necessity of paying interest on bonds semiannually and only pay interest in one lump sum upon the principal maturity date. Issuers are usually reluctant to issue capital appreciation bonds for several reasons: the interest rate for these type of bonds is normally higher than current interest bonds; the bonds are issued with either a long call or no call at all, making future refinancings to possibly lower interest rates difficult or impossible; and a postponement in repayment of any type is generally not looked upon favorably by the rating agencies. However, there are some instances where an issuer might benefit from the issuance of capital appreciation bonds. Capital appreciation bonds defer payment of interest and therefore allow the issue to phase in the debt service impact over time and effectively shift the project cost to future beneficiaries of the system. Such a shift in debt burden may make sense for a school district that anticipates substantial future growth in school-age population and tax base.

## VI. Modes of Interest Payment

The two basic modes of debt issued are fixed rate and variable rate. With fixed rate debt, the issuer locks in an interest cost for the maturity of the loan. With variable rate debt, the interest rate is tied to a specific index (usually short term) and varies with the indexed rate. The decision on which mode to use is based upon the amount of interest rate risk an issuer wants versus the reward an issuer might achieve in assuming the risk. If short-term rates are seen to be low in the future, then there is an argument to be made for issuing debt in a variable rate mode and as a result, an issuer could save on total interest expense. If short-term rates are expected to increase, then an issuer will many times issue fixed rate debt in order to avoid any higher interest rates in the future. As a result of the uncertainty of future interest rates, most issuers choose to issue debt at a fixed rate and refinance their fixed rate debt when future interest rates are beneficial.

## VII. Determining Size of Bond Issue

Many factors are analyzed when determining how large a bond issue is necessary for a project. These factors include the architect's estimates for the cost of the project. Architect's estimates must include estimated

construction costs, site costs, contingency reserves, furniture and equipment costs, architect and construction management fees. The costs of issuing the bonds and an estimate of possible investment earnings on the bond proceeds through the construction period are also recognized in determining the size of the bond issue. If construction bids have been received contingency reserves may be reduced. Interest on the debt may also need to be included as "capitalized," depending on the timing of the debt issuance and the local budgetary cycle for levying and collecting property taxes.

## VIII. Timing of the Bond Issue

Many factors are also included when determining the timing of the bond issue. These factors include:

- Start and completion of construction
- Current amortization of existing debt and opportunities for refinancing existing debt
- Desired effect of when taxes will be increased to pay for the new debt service
- Current and expected market conditions
- Other borrowing plans of the issuer
- Arbitrage opportunities
- Statutory limitations of debt issuance.

Debt issuance planning should begin as soon as the issuer has a general idea of the size of the project. Many times, there is no need to wait until construction bids are received before some type of long-term- or short-term financing is put into place. Indeed, there are many times when it is financially advantageous to issue some type of financing prior to receipt of construction bids. The possible advantages in doing so include the ability to access current market conditions which might provide the issuer with low long-term borrowing costs, the opportunity for arbitrage where the tax-exempt borrowing rate is lower than the taxable reinvestment rate, and the opportunity to designate a portion of the financing as "Bank-Qualified." Issuers can designate up to $10,000,000 in debt annually as "Bank-Qualified" debt and banks can then deduct the interest costs. This deductibility allows banks to bid more aggressively on "Bank-Qualified" debt. Issuers thus benefit from lower long-term interest rates. The additional costs associated with using short-term debt or multiple debt issues can be more than offset by the financial savings.

The determination of whether to raise temporary or permanent financing can be as much a budgetary as an economic decision. Many times, issuers want the tax impact spread over a number of years so that the increase associated with the new debt is not as great in any fiscal year. As a result, issuers finance only a portion of the project at a time. In other

instances where state law allows the structure, issuers can reduce the annual cost of a borrowing by essentially amortizing the debt associated with the new project once the existing debt is retired. However, if this structure is not allowed by law, issuers can obtain the same effect on debt service increases by issuing a series of short-term notes that are eventually refinanced by long-term financing or issuing additional bonds to pay for up to the first three interest payments.

In other instances, issuers refinance or restructure existing debt in concert with the issuance of new debt. When this structure is used, the current debt service of existing debt is lessened in the early years so that the overall impact of both new and existing debt service is phased in over time.

Many times, the financing of one project is part of an overall capital plan. As a result, the timing of all the projects must be coordinated so that the issuer's overall debt service costs are well within expectations of what is deemed affordable on an annual basis.

## IX. Financing Costs

As a rule of thumb, the financing costs of a long-term bond issue are approximately 2.5% to 3.0% of a bond issue. Therefore, the issuer issues 103% of the bonds needed to finance 100% of the project. These bond issuance costs include:

### A. Bond Discount

The commission paid to a bond underwriter to buy and re-sell the bonds. The bond discount is typically between 0.6% and 1.5% of the par amount of bonds issued depending on the type of debt security, term of the debt and the prevailing market conditions.

### B. Municipal Bond Insurance

A form of credit enhancement that automatically assigns a rating of Aaa/AAA to the issuers' bonds being sold. Municipal bond insurance is only used if the additional principal needed to pay for the insurance is more than offset by the lower interest rates and ultimately interest costs the issue receives by virtue of the fact that the bonds now carry a higher rating. Typically, the cost of bond insurance is between .20% and .30% of the total principal and interest of the new debt.

### C. Bond Counsel

Bond counsel costs can vary more than any other participant in a financing. Depending on the size and complexity of the financing, bond counsel costs can run anywhere from $7,500 to $15,000 for a straightforward financing of an issue of up to $10 million.

### D. Local Counsel

Local counsel costs are normally set by the governing body depending on the arrangement the local counsel has with the Board.

### E. Financial Adviser

Typical financial advisory fees on a straightforward $10 million financing range from $12,500 to $20,000.

### F. Rating Agency Fees

The costs rating agencies charge for assigning the bond issue a rating are based on the size of the financing with fees determined on a sliding scale.

### G. Financial Printing

Printing of Preliminary and Final Official Statements on a straightforward $10 million financing range from $2,500 to $5,000. If physical bonds are printed, the cost could range from $1,500 to $3,000.

### H. Paying Agent

If a paying agent is necessary, the annual cost is between $500 to $1,500. If the bonds are "book-entry," the school district financial officer can act as paying agent.

### I. Miscellaneous Costs

Costs included in this category are anything from costs of legal ads to any other small costs associated with an issue.

## X. The Role of Credit Ratings

A credit rating involves a judgment about the issuer's willingness and ability to pay its debt obligation. Credit ratings are used by investors as an easy way to differentiate credit quality. There are a variety of issuers–large and small, public and private, foreign and domestic–that pledge a variety of securities. The ratings published by Standard and Poor's Corporation ("S&P"), Moody's Investors Service ("Moody's") and Fitch Investor's Service ("Fitch"), the respected leaders in the field, provide a standard scale to compare dissimilar issues.

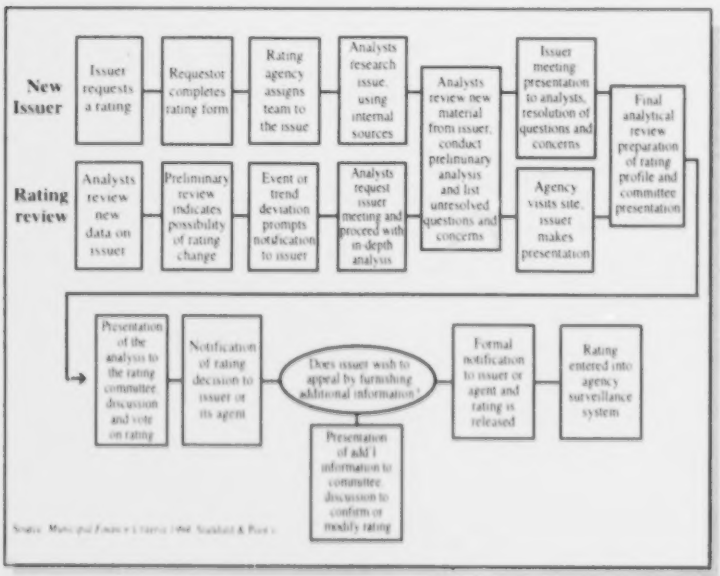
The rating agencies operate independently from any entity. Rating agencies do not participate in the financial markets as underwriters, advisers, or fund managers. The rating agencies have no authority or power, aside from the right to express opinions. Over the years, investors have come to rely upon and accept these objective opinions. Ratings are sim-

ply a credit risk evaluation. Ratings are not recommendations to buy, sell or hold a particular security, nor are they a general purpose evaluation of an issuer. The rating agencies do not perform an audit, nor do they attest to the authenticity of the information provided by the issuer.

There is a cost to the issuer for each rating agency that is asked to review the credit. As a result, most issuers find it economically beneficial to obtain at the most two different ratings. Moody's and S&P are the two services which are most often used.

## XI. The Rating Process

The following chart depicts the rating process for new issuers and for those ratings reviewed for possible changes.[1] The rating agencies typically request three or four weeks time to compile and review all research.


New Issuer
Issuer requests a rating
Requestor completes rating form
Rating agency assigns team to the issue
Analysts research issue, using internal sources
Analysts review new material from issuer, conduct preliminary analysis and list unresolved questions and concerns
Issuer meeting presentation to analysts, resolution of questions and concerns
Final analytical review preparation of rating profile and committee presentation
Rating review
Analysts review new data on issuer
Preliminary review indicates possibility of rating change
Event or trend deviation prompts notification to issuer
Analysts request issuer meeting and proceed with in-depth analysis
Agency visits site, issuer makes presentation
Presentation of the analysis to the rating committee discussion and vote on rating
Notification of rating decision to issuer or its agent
Does issuer wish to appeal by furnishing additional information?
Formal notification to issuer or agent and rating is released
Rating entered into agency surveillance system
Presentation of add'l information to committee discussion to confirm or modify rating

[1] Standard and Poor's, Inc., Municipal Finance Criteria 15 (1994).



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## XII. Factors Used by Rating Agencies

The overall debt rating process used by the rating agencies is complex and involves the examination of the issuer on a macro and micro level. The four main factors considered by the major rating agencies on general obligation issues include economic, financial, debt and administrative. Although some criteria are weighted more than others, there is no specific weight the agencies assign to any variable.

### A. Economic Factors

Factors include demographics of the population served, tax base diversity and growth, diversity and growth of the employment base, and income levels of the population served by the project. These factors are also compared on a regional and national level to determine credits with similar credit quality.

### B. Financial Factors

In this category, the financial indicators include accounting and reporting methods, sources of revenues and uses of expenditures, annual operating histories, balance sheet history, budget and financial planning, pension fund position and other long-term obligations.

### C. Debt Factors

The analyst examines the nature of the pledged security, the structure of the current and planned debt, the current debt burden, and the future financing needs of the issuer.

### D. Administrative Factors

The rating agencies also want to know how a government is organized to provide governmental functions, how it is planning for the future, what management controls are in place to govern, how timely the government adopts its budget, and what type of capital improvement program the issuer has developed and if it is following the plan. The rating agencies also examine the rate of property tax collection, the status of labor contracts, and the timeliness of state funding of local education.

## XIII. Information the Rating Agencies Use in Their Analysis

When submitting materials to the rating agencies, the following items are usually considered:

- Five years of audited financial reports
- Current year's budget
- Bond resolution or trust indenture, including supplemental resolution or indenture, if appropriate

- Anticipated capital improvement program
- Three to five years of operating statistics
- History and projection of student enrollment
- Population trends
- Income trends
- Composition of employment by sector
- Largest employers in service area
- Tax base trends
- Building permit activity
- Sales tax trends.

## XIV. Rating Agency Meeting and Timetable

Generally, information and materials related to the issuer's credit position and proposed debt issue are submitted two to three weeks in anticipation of the planned date for pricing or execution of a firm's underwriting agreement. If the issuer has not before received a rating or if the credit position has changed significantly since the last rating, the issuer may want to arrange a meeting with rating agency officials to review credit considerations. The financial adviser advises the issuer regarding the need for such a meeting and coordinates all preparations for such a meeting. The bond rating can be expected to be released one to five days prior to the date of sale for pricing.

## XV. Implementation of a Financing Plan

Once the financing plan is approved and the size of the debt issue is determined, the financial adviser reviews provisions related to early redemption options and premium or discount pricing restrictions which become part of the official "terms of offering." A final determination must also be made regarding the method of sale. Depending on statutory limitations, debt may be issued on either a negotiated or competitive basis. With a negotiated sale, the school district issue selects an underwriter or group of underwriters and deals with the selected underwriter(s) on the pricing of the debt issue. On a competitive sale transaction, the preliminary official statement and terms of offering are distributed to a larger number of underwriters and banks and a time for submission of bids is established. Bidders submit offers to purchase including specification of underwriting fees and coupon interest rates. Alternative bids are evaluated by the financial adviser for compliance with the terms of offering and the issue awards the sale to the bidder submitting the lowest cost proposal, as defined in the terms of offering. The following describes

the general attributes that argue for a competitive versus a negotiated sale. The decision is made depending primarily upon the attributes of the issue and market conditions at the time of sale.

ATTRIBUTES WHICH ARGUE FOR A COMPETITIVE SALE

Well-known issuer
Rating of A or higher
Conventional issue structure
Standard security provisions
Good credit quality
Few or no tax law concerns
Tax-exempt issue
Strong market with high demand
Stable, predictable market

ATTRIBUTES WHICH ARGUE FOR A NEGOTIATED SALE

New issuer
Rating lower than A
Innovative debt structure
Unusual security pledge
Concern about credit quality
Potential tax law concerns
Taxable issue
Weak market with low demand or high supply
Volative market with rapid changes

The financial adviser evaluates market conditions, features of the credit, and the financing time schedule associated with the proposed bond sale. These and other factors are used to develop a recommended method of sale.

When it is determined that a negotiated sale is appropriate, the financial adviser works with issuer officials to develop a detailed request for underwriting proposals. This approach to the selection of its underwriting group gives the issuer an opportunity to control all components of the underwriting spread and identify those firms which are most experienced with marketing securities of the type being offered. Once the underwriting group has been chosen, the financing documents are reviewed by all financing team members and the final terms of offering are deter-

mined. The financial adviser negotiates with the underwriter(s) on the issuer's behalf to ensure that the issue is aggressively priced relative to current market conditions and that the lowest possible interest rate is secured.

When a competitive sale is used, the financial adviser works with bond counsel to complete the terms of offering specifying the form of bids and prepare and distribute the preliminary official statement which contains the terms of offering and disclosure information as required by the Municipal Security Rulemaking Board (MSRB).

## XVI. Closing and Delivery of Funds

Once the debt issue is priced and all terms are fixed, the financial adviser works with all parties involved to complete tasks required for closing or delivery of funds. These tasks include printing and preparing bond certificates (if printed bonds are used), completing the final official statement, preparing closing documents, arranging for the transfer of funds and investment of funds.

The financial adviser works with the issuer's bond counsel and other members of the financing team to prepare and review all required documentation. This includes direct contact with the official statement printer and bond printer, as well as coordination of bond registration with the underwriter and registrar. The financial adviser arranges for either registration of the bonds with The Depository Trust Co. or delivery of the bonds and the simultaneous transfer of "same day" funds into the accounts identified by the issuer. If the transaction is a refunding, the financial adviser assists in the purchase of U.S. Treasury securities for the escrow. Upon delivery, the financial adviser works with school officials to ensure that bond proceeds are invested to optimize investment earnings consistent with applicable statutory limitations.

## XVII. Conclusion

Sound financial planning is an integral part of implementing school facilities construction projects. The financial adviser offers the local school district expertise and experience in the capital financing markets and acts in a fiduciary capacity to represent and advocate the school district's financial interests.

# NOTES

# ACCESSIBILITY OF A PUBLIC ENTITY'S FACILITIES UNDER THE AMERICANS WITH DISABILITIES ACT

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## I. INTRODUCTION

Although most people think of the Americans with Disabilities Act, 42 U.S.C.A. § 12101, *et seq.* ("ADA")[1] as an employment statute, this landmark legislation was designed to remove *all* barriers that prevent disabled Americans from accessing facilities and services commonly open to the nondisabled. Removing barriers not only applies to employment; it means removing the physical barriers that prevent the disabled from properly using public buildings and other facilities. Building accessibility under the ADA is regulated by Title II, which states the general rule as follows:

> Subject to the provisions of this subchapter, no qualified individual with a disability shall, by reason of such disability, be excluded from participation in or be denied the benefits of the services, programs, or activities of a public entity, or be subjected to discrimination by any such entity.[1]

Title II applies only to a "public entity," which according to the statute is any state or local government, or any department, agency, special purpose district or other instrumentality of a state or local government.[2] Title II is intended to benefit a "qualified individual with a disability" which is defined as an individual with a disability who, with or without reasonable modifications to rules, policies, or practices, the removal of architectural, communication, or transportation barriers, or the provision of auxiliary aids and services, meets the essential eligibility requirements for receipt of services or the participation in programs or activities provided by a public entity.[3]

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[1] 42 U.S.C.A. § 12132.
[2] 42 U.S.C.A. § 12131(1). "Public entity" is also defined as the National Railroad Passenger Corp. and any commuter authority. Access to public transportation is beyond the scope of this chapter.
[3] 42 U.S.C.A. § 12131(2).

While the statutory language of title II is somewhat spartan, it is further defined and elaborated on by an extensive set of federal regulations, which are codified in the Code of Federal Regulations at 28 C.F.R. part 35, et seq.,[4] and state in relevant part:

> Except as otherwise provided in § 35.150, no qualified individual with a disability shall, because a public entity's facilities are inaccessible to or unusable by individuals with disabilities, be excluded from participation in, or be denied the benefits of the services, programs or activities of a public entity, or be subjected to discrimination by a public entity.[5]

This provision applies to a public entity's programs, even where no individuals with disabilities live in the area served by the facility.[6] The general rule under the ADA is that the programs of a public entity must be readily accessible when viewed as a whole. However, the public entity is not required to make each and every existing facility accessible. Although title II applies to all currently existing buildings and facilities, it also applies in two more specific situations: when existing buildings are being altered, or when new buildings are being constructed. Because the effect of title II is different in each situation, they will be examined individually.

## II. Existing Facilities

Compliance with the ADA in existing facilities creates many problems for the obvious reason that the facilities have already been built; it does not allow for the requirements of title II to be planned into the construction of the building, as is possible with new construction or alterations. However, the ADA does not necessarily require a public entity to completely rebuild its facility to ensure accessibility. Physical changes

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[4] On June 20, 1994, the Attorney General published a new set of Proposed Rules at 59 Fed. Reg. 31,808 (1994), which contains several additions and amendments to the prior regulations under title II. In addition, the Architectural & Transportation Barriers Compliance Board issued a proposed amended version of the Americans with Disabilities Act Accessibility Guidelines for Buildings and Facilities ("ADAAG") the same day, published at 59 Fed. Reg. 31,676 (1994). These Proposed Rules are not binding on the public until they become final, but since they are likely to be approved without too many changes, this chapter will focus on them. For assured compliance, copies of the Final Rules should be obtained as soon as they are available.

[5] 28 C.F.R. § 35.149.

[6] Title II Technical Assistance Manual, II-5.1000.

to buildings are required only when there is no other feasible way to make the program accessible.

As noted above, title II applies to existing "facilities." Under the Act, a "facility" is all or any portion of buildings, structures, sites, complexes, equipment, rolling stock or other conveyances, roads, walks, passageways, parking lots, or other real or personal property, including the site where the building, property, structure, or equipment is located.[7] The requirement for existing facilities is that services, programs, or activities must be "readily accessible to and usable by individuals with disabilities, "*when viewed in their entirety*."[8] This requirement does *not* require that a public entity make *each* of its facilities accessible to and usable by individuals with disabilities.[9] It also does not require a public entity to take any action that would threaten or destroy the historic significance of historic property,[10] or that would fundamentally alter the nature of a service, activity or program or entail undue financial or administrative burden.[11]

According to the Title II Technical Assistance Manual, "a public entity does not have to take any action that it can demonstrate would result in a *fundamental alteration* in the nature of its program or activity or in *undue* financial and administrative *burdens*."[12] This is known as the fundamental alteration or undue burden exception. The ADA regulations list several steps that must be taken before a public entity may claim that these exceptions apply. First, a determination that any proposed action would fall under this exception must be made by the head of the public entity or his designee. It must be based on all available resources, and must be accompanied by a written statement setting out the reasoning. In addition, the public entity must take the next best course of action that would not result in the undue burden or fundamental alteration, and that would ensure individuals with disabilities access to programs.[13] The "undue burden" defense is only available for existing facilities; it does not apply to alterations of existing facilities or the construction of new facilities.[14]

Although structural changes in a building, or the acquisition or construction of additional facilities may be the most effective and most obvious method of achieving access, they are not always necessary to provide accessibility.[15] Acquiring or redesigning equipment, providing aides

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[7] 28 C.F.R. § 35.104.
[8] 28 C.F.R. § 35.150(a).
[9] 28 C.F.R. § 35.150(a)(1).
[10] 28 C.F.R. § 35.150(a)(2).
[11] 28 C.F.R. § 35.150(a)(3).
[12] II-5.1000 (emphasis added).
[13] 28 C.F.R. § 35.150(a)(3).
[14] Kinney v. Yerusalim, 9 F.3d 1067, 1074 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1545 (1994).
[15] II-5.2000.

to beneficiaries, or providing services at alternate sites are other methods of making programs accessible. The Technical Assistance Manual gives an example of such alternative methods: assume that a public library's open stacks are located on upper floors having no elevator. As an alternative to installing a lift or elevator, library staff may retrieve books for patrons who use wheelchairs.[16] Such a service cannot be provided half-heartedly; the aides must be available during the operating hours of the library. As another example, a public university that conducts a French course in an inaccessible building may relocate the course to a building that is readily accessible.[17] Therefore, structural changes in existing public facilities are not required where other methods are effective in achieving accessibility.

While innovative alternatives to structural changes are permitted under title II, public entities should still take care in selecting which alternative they shall use. When several different means of providing a service are possible, priority should be given to the one that provides the service in the most integrated location.[18] For example, suppose a small school has a one-room library with several steps leading up to its entrance. The school can make its services accessible in several ways. It can construct a wooden ramp quickly and cheaply. On the other hand, another alternative would be to have an aide take a "book cart" around to the classrooms, so disabled students may have books brought to them. Under title II, the school should build the ramp because it offers library services to disabled students in the same setting as other students.[19]

The regulations under title II suggest several possible methods for ensuring a public entity's programs in existing facilities are accessible to individuals with disabilities:

1. Redesign of equipment,
2. Reassignment of services to accessible buildings,
3. Assignment of aides to beneficiaries,
4. Home visits,
5. Delivery of services at alternative accessible sites,
6. Alteration of existing facilities,
7. Construction of new facilities, or:
8. Use of accessible rolling stock or other conveyances.[20]

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[16] II-5.2000.
[17] *Id.*
[18] 28 C.F.R. § 35.150(b)(1).
[19] II-5.2000.
[20] 28 C.F.R. § 35.150(b)(1).

One method of providing accessibility to a public entity's facilities that is generally *not* acceptable, however, is carrying a disabled individual to the programs or services.[21] This has been found to undermine the goal of fostering independence through accessible programs. Two exceptions to this general rule do exist, however: carrying individuals is allowed as a temporary expedient while construction for permanent structural changes is underway, and in "manifestly exceptional cases" where carriers are formally instructed on the safest and least humiliating manner of carrying, and where the service is provided in a reliable manner. As with carrying, the use of back doors and freight elevators to satisfy title II requirements that a public entity's programs be accessible is acceptable, but only as a last resort and only where comparable services are provided.[22] For instance, having to travel excessive distances or through nonpublic areas (kitchens, storerooms, etc.) would not provide a comparable service; or having to knock at a locked back door while the front door is unlocked would also not provide comparable access.

Where alternative methods for providing services are simply not possible, all structural changes needed to provide accessibility should have been completed no later than January 26, 1995. A transition plan for structural changes developed with the assistance of outside individuals or groups should have been in place since July 26, 1992, for public entities that employ fifty or more people. The plan should identify physical obstacles in the facility, the methods to be used to eliminate them, and a schedule for doing so.

## III. New Construction

The ADA applies to all construction for public entities commenced after January 26, 1992.[23] The general rule for new construction is that all buildings shall be designed and built so that the facility is "readily accessible to and usable by individuals with disabilities."[24] This means the facility must be designed, constructed, or altered in strict compliance with a design standard. A public entity must consider the site and location of a new facility, so disabled individuals are not excluded from the services offered at the new facility.[25] Section 35.151 of the regulations applies to the new construction of parts of facilities, as well as entire

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[21] II-5.2000.

[22] II-5.2000.

[23] The regulations concerning new construction are codified at 28 C.F.R. § 35.151, along with those regarding alterations. Under the Proposed Rules, § 35.151 deals solely with new construction.

[24] 28 C.F.R. § 35.151(a).

[25] 28 C.F.R. § 35.130.

buildings. Public entities must use either the Uniform Federal Accessibility Standards ("UFAS") or the Americans with Disabilities Act Accessibility Guidelines for Buildings and Facilities ("ADAAG"). However, the recent Proposed Rules by the Department of Justice would eliminate this choice and require compliance with ADAAG as published at 59 Fed. Reg. 31,676 (1994). Even where the choice is still allowed, however, each facility or project must follow one standard completely and alterations to that facility must follow the same standard. Departure from either standard may be permitted if it is clear that equivalent access is provided. The technical differences between the two standards may be found in the Title II Technical Assistance Manual at II-6.3100.

The Proposed Rules have added several exceptions to the "readily accessible" rule to harmonize title II with title III of the Act, which prohibits discrimination on the basis of disability by private entities that "own, lease (or lease to) or operate a place of public accommodation."[26] Full compliance is not required where it is "structurally impracticable" to meet the requirements of title II.[27] Full compliance will be considered structurally impracticable only in those rare circumstances when the unique characteristics of terrain prevent the incorporation of accessibility features. For instance, it would be "structurally impracticable" to provide access to someone in a wheelchair to a building that stands on stilts over water or marshlands. Likewise, a facility built into the side of a hill or mountain may be equally difficult to make accessible to individuals with certain types of disabilities. This is a very narrow exception, though, and where full compliance is structurally impracticable, compliance is required to the maximum extent practicable. Any portion of a facility that may be made accessible must be made accessible, even where compliance for the entire facility is structurally impracticable. In addition, where accessibility for certain disabilities (i.e., people in wheelchairs) is structurally impracticable, accessibility for people with other disabilities (i.e., people on crutches) must still be ensured.

## IV. Alteration of Facilities

According to 28 C.F.R. § 35.151(b), any facility of a public entity which is altered in a way that could affect the usability of the facility, or any part of it, shall be altered in such a manner that the altered part is "readily accessible to and usable by individuals with disabilities," to the maximum extent feasible.[28] Therefore, alteration is treated like new con-

[26] 42 U.S.C. § 12182(a).
[27] 59 Fed. Reg. 31,814.
[28] 28 C.F.R. § 35.151(b).

struction. This section applies to any alteration begun after January 26, 1992. Because all structural changes required for existing facilities should have been finished by January 26, 1995, the focus of the Proposed Rules has shifted to address alteration of a public entity's facility in more detail.[29] The term "alteration" includes, but is not limited to, remodeling, renovation, rehabilitation, reconstruction, historic restoration, resurfacing,[30] changes or rearrangement in structural parts or elements, and changes or rearrangement in the plan configuration of walls and full-height partitions. What the term "alteration" does *not* include is normal maintenance, re-roofing, painting or wallpapering, asbestos removal, or changes to mechanical or electrical systems–*unless they affect the usability of the building or facility*.[31] For instance, where an asbestos removal project is combined with a restructuring of a facility's wall plans, this would constitute an alteration, subject to the requirements of title II.

The requirement that alterations be carried out in a manner which would make a facility "readily accessible" is only "to the maximum extent feasible."[32] This occasionally applies where the nature of an existing facility makes it virtually impossible to comply fully with the applicable accessibility standards. In these cases, what can be made fully accessible shall be. In addition, where accessibility for certain disabilities is structurally impracticable, accessibility for people with other disabilities must still be ensured.

The Proposed Rules have added a "path of travel" requirement at 28 C.F.R. § 35.153 to harmonize title II with title III.[33] The proposed rule provides:

> An alteration that affects or could affect the usability of or access to an area of a facility that contains a primary function shall be made so as to ensure that, to the maximum extent feasible, the path of travel to the altered area and the restrooms, telephones, and drinking fountains serving the altered area, are readily accessible to and usable by individuals with disabilities.[34]

The scope of the proposed rule would include, for example, meeting rooms at a conference center. The Technical Assistance Manual also states

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[29] *See* Proposed Rules 59 Fed. Reg. 31,814 at § 35.152.

[30] *See* Kinney v. Yerusalim, 9 F.3d at 1074.

[31] 59 Fed. Reg. 31,814 at § 35.152.

[32] 28 C.F.R. § 35.151(b).

[33] *See* 59 Fed. Reg. 31,808 (1994).

[34] *Id.* A "primary function" is designed as a major activity for which the facility is intended.

that public meetings held in existing buildings must be readily accessible to individuals with disabilities.[35] This should include readily accessible telephone and rest room services, where such services are provided for meeting attendees. Because the "primary function" requirement only applies to major activities for which the facility is intended, this requirement does not extend to the entire building where a meeting is to be held, but only to the meeting facilities.[36] Likewise, restrooms in a public school would not be considered areas that contain a primary function, because schools are not built to provide restrooms as a major activity. However, restrooms at a rest area on a highway would be considered areas that contain a primary function, because that is the primary purpose of a rest area. The primary function requirement also includes the offices and other work areas of a building in which activities of a public entity are performed.[37] It does *not* include such places as mechanical rooms, boiler rooms, supply storage rooms, employee lounges, locker rooms, janitorial closets, or entrances and corridors. In addition, alterations to windows, hardware, controls, electrical outlets, and signage are not alterations that affect the usability of or access to areas containing a primary function.

The "path of travel" is defined as a continuous, unobstructed way of pedestrian passage by means of which the altered areas may be approached, entered, and exited, and which connects the altered area with an exterior approach, an entrance to the facility, and other parts of the facility.[38] This includes walks and sidewalks, curb ramps and other interior and exterior pedestrian ramps, clear floor paths through lobbies, corridors, or rooms, parking access areas, elevators and lifts, and the restrooms, drinking fountains, and telephones serving the altered areas. The path of travel requirement explicitly applies to people who use wheelchairs.[39]

Title II contains one exception to the "path of travel" alterations requirements in situations where the cost and scope of such alterations are disproportionate to the cost of the overall alteration. In general, paths of travel that cost over twenty percent of the cost of the alteration to the primary function area are considered disproportionate.[40] The costs of a path of travel can include the costs associated with providing accessible entrances and routes to the altered areas, such as widening doors and installing ramps. It may also include the costs associated with making

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[35] II-5.1000.
[36] II-5.1000.
[37] 59 Fed. Reg. 31,814 at § 35.153(b).
[38] *Id.* § 35.153(c)(1).
[39] *Id.* § 35.153(a).
[40] *Id.* § 35.153(d)(1).

restrooms accessible, such as installing grab bars, enlarging toilet stalls, insulating pipes, and installing accessible faucet controls. The costs associated with providing accessible telephones can include relocating the telephone to an accessible height, installing amplification devices, or installing a telecommunications device for deaf persons (TDD). Lastly, path of travel costs could also include the costs associated with relocating an inaccessible drinking fountain.

To the extent a path of travel cannot be made fully accessible without incurring disproportionate costs, it shall be made as fully accessible as possible. In choosing which accessible elements to provide, priority must be given to those elements which provide the greatest access, in the following order:

1. An accessible entrance;
2. An accessible route to the altered area;
3. At least one accessible restroom for each sex or a single unisex restroom;
4. Accessible telephones;
5. Accessible drinking fountains; and
6. When possible, other accessible elements, such as parking, storage, and alarms.[41]

Title II explicitly warns against trying to evade one's duties under the Act. The facility owner may not escape the obligation to provide an accessible path of travel by performing a series of smaller alterations to areas served by one path of travel, if the alterations could have been done at the same time. If a primary function area is altered without providing a path of travel, and additional alterations are performed within a three-year period, the total cost of alterations to the primary function area within the three-year period will be used in determining if a path of travel cost is disproportionate.

## V. Curb Ramps

Curb ramps are a subject of great discussion under title II of the ADA. According to the regulations, public entities must prepare a schedule for providing curb ramps at pedestrian walkways as part of its transition plan.[42] Priority shall be given for walkways serving the following:

1. State and local governmental offices and facilities,
2. Transportation;

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[41] *Id.* § 35.153(e)(2).
[42] 28 C.F.R. § 35.150(d)(2).

3. Places of public accommodation; and
4. Employees.

While curb ramps may be built at every point where a pedestrian walkway intersects a curb to improve accessibility, public entities are not necessarily *required* to construct a ramp at every such intersection. Disabled pedestrians may be required to use alternative routes, if it requires only a "marginally longer route." In addition, entities may claim the fundamental alteration and undue burden limitations to limit the number of ramps they are required to install under title II. The Department of Justice suggests an ongoing procedure for considering and establishing ramps upon demand, for highly traveled areas.

Newly constructed or altered streets must contain curb ramps or other sloped areas at all pedestrian walkways.[43] Curb ramps must be installed whenever a street is altered in such a way as to affect its usability, even where the curbs themselves are not altered. This requirement has generated one of the only accessibility lawsuits brought so far under title II. In *Kinney v. Yerusalim*,[44] a nonprofit organization brought suit to require the city of Philadelphia to install curb ramps at intersections when it resurfaced the streets. The city argued it was only altering the streets and not the curbs. The court held that because the resurfacing of the streets made them more usable, such increased utility must be made fully accessible to the disabled through the provision of curb ramps for greater accessibility.

## VI. Private Universities

While private universities are not subject to title II, they are subject to title III, which includes an "undergraduate, or post graduate private school, or other places of education."[45] However, the requirements under title II and title III, at a broad level, are very similar. Moreover, both title II and title III use the ADAAG for technical compliance. Title III requires all places of public accommodation to remove all architectural barriers in existing facilities where the removal is "readily achievable."[46]

The accessibility of the program and services is the key difference between the "program accessibility" standard under title II and the "readily achievable barrier removal" standard under title III. Title III requires covered private entities remove barriers to accessibility where "readily

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[43] 28 C.F.R. § 31.151(e).
[44] Kinney v. Yerusalim, 9 F.3d 1067 (3d Cir. 1993), *cert. denied*, 114 S. Ct. 1545 (1994).
[45] 42 U.S.C. § 1218(7).
[46] 42 U.S.C. § 1218(b)(2)(A) (iv).

achievable," even where the private services can be made available through other means. In contrast, public entities *are not* required to remove barriers under title II, even if "readily achievable," where the entity can provide the services in another manner.[47] While under title II the duty to remove barriers does not apply to areas which are exclusively employee work areas,[48] title I may require such barriers to be removed as an accommodation to a disabled employee.

## VII. Historical Buildings

Historical buildings have a special status under title II of the ADA. Title II does not require a public entity to take any action "that would threaten or destroy the historic significance of an historic property."[49] A "historic property" is defined as "those properties that are listed or eligible for listing in the National Register of Historic Places or properties designated as historic under State or local law."[50] Alterations made to historic buildings must comply with ADAAG § 4.1.7, to the maximum extent feasible. Priority must be given to methods which allow physical access by individuals with disabilities. If it is not feasible to provide physical access to a historic property in a manner that will not destroy its historic significance, however, "alternative methods of access shall be provided" by using audio-visual materials and devices to depict those portions of a historic property which cannot otherwise be made accessible, assigning persons to guide individuals with handicaps into or through portions of historic properties that cannot otherwise be made accessible, or adopting other innovative methods.[51]

## VIII. Compliance with Title II of the ADA

Individuals or classes of individuals who believe they have been discriminated against under title II may file a complaint with the appropriate agency.[52] The designated agency may investigate or conduct compliance reviews when it receives information regarding a possible failure to comply with title II. Informal resolution of the complaint should be attempted. If informal resolution does not work, then the agency may issue a Letter of Findings which will indicate the findings of fact and conclusions of law and a description of a remedy for each violation.[53]

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[47] II-5.2000.
[48] 56 Fed. Reg. 35,568.
[49] 28 C.F.R. § 35.150(a)(2).
[50] 28 C.F.R. § 35.104.
[51] 28 C.F.R. § 35.150(b)(2).
[52] 28 C.F.R. § 35.170 (1994).
[53] 28 C.F.R. § 35.172(a).

Because there is no requirement under the Act to exhaust administrative remedies, a private complainant may file a private suit at any time, regardless of whether the agency has found any violations.[54] Public agencies are directed to comply with investigations and make necessary sources of information available. Asserted considerations of privacy or confidentiality are not a defense to requests for information in a compliance review. The government will keep such information confidential, however, except where there is a need for formal enforcement proceedings or as otherwise required by law. If noncompliance is not resolved through informal means, the agency may refer the matter to the Justice Department for further action.

[54] II-9.2000.

# FUNDAMENTALS OF COMPETITIVE BIDDING

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## I. Introduction

The construction contracts of governmental entities usually involve large amounts of taxpayer money. As a result, most public improvements that include major construction must conform to statutory competitive bidding procedures. However, some exceptions to the competitive bidding requirements are available, such as small purchases, single source procurements or emergency procurement.[1]

Competitive bidding serves several important functions. First, competitive bidding aids in producing the best product at the lowest possible cost to the taxpayers.[2] Competitive bidding also guards against favoritism, dishonesty, fraud and corruption and is intended to benefit taxpayers and not to benefit bidders.[3] Competitive bidding statutes additionally afford an opportunity for free competition.[4] Thus, the courts strictly construe competitive bidding statutes because they are to be administered with sole reference to the public interest.[5]

## II. Contracts Subject to Competitive Bidding

Unless public funds are not involved, some bidding process is generally required.[6] Generally state or local statutes define which contracts are subject to the competitive bidding requirements.[7] Some statutes, how-

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[1] The Model Procurement Code for State and Local Governments § 11-101 (1979).
[2] City of Des Moines v. Master Builders, 498 N.W.2d 702, 704 (Iowa 1993); *See also* City of New York Policy Bd. Rules § 1.01(b) (1993).
[3] Conduit & Found. Corp. v. Metropolitan Transp. Auth., 485 N.E.2d 1005 (N.Y. 1985).
[4] McQuillin Mun. Corp. §29.29 (3d ed. 1990).
[5] *Id.*
[6] Webster v. Village of Fairport, 576 N.Y.S.2d 491 (Supp. 1991) (bidding not required if expenditure of public funds are not involved).
[7] The City of New York requires competitive bidding for the procurement of: [A]ll goods, services or construction to be paid for out of the City Treasury or out of monies under the control of or assessed or collected by the City of New York; [A]ll goods, services or construction to be procured by an entity, the majority of the members of whose board are officials of the City of New York or are individuals appointed directly or indirectly by officials of the City of New York. City of New York Procurement Policy Bd. Rules § 1-01(a); *see also* Ariz. Rev. Stat. Ann. § 41-2501 (West Supp. 1994); Iowa Code §§ 384.96, 73A.2 (1995).

ever, allow the governing body wide discretion in determining whether to use competitive bidding procedures.[8] When this occurs, an alternative procedure is sometimes required.[9] In some jurisdictions, a contract may be awarded without competition when it is determined there is only one source for the required construction item.[10]

Under most statutory schemes, the governing body is prohibited from letting contracts involving an expenditure of more than a specified sum without first submitting the contract to competitive bidding. Because the minimum bidding amount requirement must be observed in good faith, the governing body cannot divide the work and let it under several contracts with each amount falling below the minimum amount required for competitive bidding.[11]

## A. Consequences of Avoiding Statutory Requirements

As a general rule, where competitive bidding procedures are required and not followed, the contract is invalid and cannot be the basis of liability against the governmental entity.[12] Generally, the contractor is unable to recover on an implied contract even if the governmental entity received the benefits of the contract.[13] Some jurisdictions, however, have allowed the contractor to recover even though the competitive bidding statutes were avoided.[14]

## B. Emergency Purchases

The competitive sealed bidding process may be avoided if a verifiable emergency exists which threatens the public health, welfare, or safety of the community and requires immediate acquisition of goods or services. The governing body may need to produce a written determination or architect or engineer's certificate verifying the necessity of the emergency procurement.[15] The governing body, however, should use the emer-

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[8] *See* IND. CODE ANN. § 4-13.4-5-4 (Burns Supp. 1994).

[9] *Id.*

[10] MODEL PROCUREMENT CODE § 3-205.

[11] McQuillin Mun. Corp. § 29.33; *see, e.g.*, Elview Constr. Co. v. North Scott Community Sch. Dist., 373 N.W.2d 138, 142 (Iowa 1985); MODEL PROCUREMENT CODE § 3-204. *E.g.*, Kunkle Water & Elec., Inc. v. City of Prescott, 347 N.W.2d 648, 655 (Iowa 1984). West Harrison Community Sch. Dist. v. Iowa State Bd. of Pub. Instruction, 347 N.W.2d 684, 688 (Iowa Ct. App. 1984).

[12] McQuillin Mun. Corp. § 29.41.

[13] *Id.*

[14] *Id.*; *see also* St. Louis Terminals Corp. v. City of St. Louis, 535 S.W.2d 593, 596 (Mo. Ct. App. 1976) (granting an exception to a general ordinance requiring competitive bidding to operate city wharf).

[15] Daves Ins. Agency, Inc. v. State, 488 So. 2d 705 (La. Ct. App. 1986); IND. CODE ANN. § 4-13.4-5-7(1) (Burns Supp. 1994); IOWA CODE § 384.103(2) (1995); MD. STATE FIN. & PRAC. CODE ANN. § 13-108 (1995); The Model Procurement Code § 3-206.

gency procurement procedures cautiously as many courts strictly construe and administer bidding statutes.[16]

## C. Questionable Purchases

Generally all contracts should be awarded by competitive sealed bidding procedures.[17] Sometimes, however, a governing body may be uncertain on whether a particular item or project should be submitted to competitive bidding procedures because the item or project may not "squarely" fit within one of the statutory exceptions to competitive bidding or may not "squarely" fit within the statutory definition of "public improvement." In those instances, the final decision should be left with the governing body. The governing body should make an entry in the minutes, where the project is authorized, that competitive bidding is not required and the reasons why the governing body believes that is the case. If the decision is made not to publicly bid the questionable project or item, the purchasing agent may obtain quotes from possible suppliers. If quotes are obtained this may be the result of an informal bidding procedure in which the suppliers submitted bids or quotations.

## D. Service Contracts

The Model Procurement Code for State and Local Governments defines "services" as "the furnishing of labor, time, or effort by a contractor not involving the delivery of a specific end product other than reports which are merely incidental to the required performance."[18]

The various types of service contracts include, but are not limited to, consulting, personal, professional, technical and purchase of client services.[19] Some jurisdictions specifically include service contracts in their competitive bidding statutes.[20] Although not expressly excluded, other jurisdictions do not require competitive bidding for service contracts.[21] If unsure, a governing body may wish to resolve the issue in favor of competitive bidding to ensure maximum savings for the public.[22] On the other hand, because the services rendered by certain professions covered under service contracts involve extensive analysis, the exercise of discretion and independent judgment and an advanced and specialized knowl-

[16] State v. Ladner, 512 So. 2d 1271 (Miss. 1987) (finding the school board acted improperly when it awarded a contract to repair a school building damaged by a tornado without first obtaining competitive bids from at least three reputable concerns as required by state statute, *id.*).

[17] *See* MODEL PROCUREMENT CODE § 3-201.

[18] THE MODEL PROCUREMENT CODE § 1-301(19).

[19] *Id.*

[20] *Id.*, ARIZ. REV. STAT. ANN. § 41-2553 (West 1992).

[21] IND. CODE § 4-13.4-5-7(4)(A) (Burns Supp. 1994); IOWA CODE § 573.1 (1995).

[22] Miller v. City of Des Moines, 122 N.W. 226, 230 (Iowa 1909).

edge or skill, the governing body may not wish to submit the contract to competitive bidding procedures.[23]

## III. Preliminary Procedures and the Invitation for Bidding

When the governing body has decided a project must be publicly bid, a number of procedures must be followed to comply with the competitive bidding requirements.

### A. Tax-Exempt Financing

Federal Income Tax Regulations require municipalities to satisfy a temporary period requirement to avoid federal arbitrage rebate penalties.[24] The temporary period requirement only applies, however, if the issuer reasonably expects to satisfy an expenditure test, a time test, and a due diligence test.

The expenditure test is met if at least 85% of the net sale proceeds of the issue are allocated to expenditures on a capital project by the end of the temporary period.

The time test is satisfied if the issuer incurs, within six months of the issue date, a substantial binding obligation to a third party to expend at least 5% of the net sale proceeds of the issue on capital projects. An obligation is not binding if it is subject to contingencies within the issuer's control.

The due diligence test is satisfied if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures are undertaken with due diligence.

The governing body may be required to certify that it has incurred a substantial binding obligation, or will incur a substantial binding obligation, within six months. Since contracts that do not satisfy competitive bid requirements are void, complying with competitive bid requirements could impact the utility's ability to issue tax-exempt obligations.

If improvements are done in advance of the issuance of bonds and are paid from funds on hand, the governing body can issue tax-exempt bonds to reimburse those expended funds or amounts only if an official intent resolution is adopted or other official action required by the federal regulations is taken within sixty days of the expenditure that expresses the intent of the governing body to reimburse the fund or account with the proceeds of tax-exempt bonds.

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[23] Model Procurement Code § 3-202, cmt.1.

[24] Treas. Reg. § 1.148-2(e).

## B. Bidder Prequalification

A governing body may request prospective bidders to qualify for bidder lists.[25] "Prequalification is a tool which allows agencies to complete an evaluation of the capability and qualifications of potential contractors before invitations for bids or requests for proposals are issued for specific contracts."[26] Prequalification is not a conclusive determination of responsibility and does not necessarily represent a finding that a prequalified bidder is responsible.[27]

The distribution of the solicitation should not be limited to prequalified bidders and bidders should not be disqualified from a contract solicitation for failure to prequalify.[28]

## C. Public Hearing

In those jurisdictions requiring that only certain contracts be let for competitive bidding, a governing body may be required to hold a public hearing after adopting the proposed plans, specifications and form of contract to be used.[29] Generally, the hearing must be held in the location affected and notice of the meeting must be given by the governing body.[30]

To substantially reduce the time required to comply with the public bidding requirements, the governing body may approve the plans at the same meeting that authorizes the Invitation for Bids. The governing body may hear objections to the project, approve the public improvement, and then authorize the Invitation to Bid.

## D. Invitation for Bids

The request for bids must not unduly restrict competition. If specifications are drawn that have the effect of confining the bidding to one prospective contractor, even though others are engaged in the same business and can do the work or supply the materials, the contract let under such specifications may be void.[31]

### 1. Specifications

A "specification" is a "description of the physical or functional characteristics, or of the nature of a supply, service or construction item. It

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[25] " 'Bidder prequalification' means determining in accordance with rules adopted pursuant to this chapter that a prospective bidder or offeror satisfies the criteria for being included on the bidder's list." ARIZ. REV. STAT. ANN. § 41-2531(1) (West Supp. 1994).

[26] City of New York Procurement Policy Bd. Rules § 3-11(a).

[27] MODEL PROCUREMENT CODE § 3-402, cmts.

[28] MODEL PROCUREMENT CODE FOR STATE AND LOCAL GOVERNMENTS, RECOMMENDED REGULATIONS, R3-402.01.1 (1979).

[29] IOWA CODE §§ 83A.2, 384.102 (1995).

[30] *Id.* §§ 70A.2, 362.3.

[31] McQuillin Mun. Corp. at § 29.49. *See* Gerzof v. Sweeney, 211 N.E.2d 826 (N.Y. 1965).

may include a description of any requirement for inspecting, testing, or preparing a supply, service, or construction item for delivery."[32] Specifications should be generic in nature and emphasize functional or performance criteria.[33] The specifications, however, should be sufficiently definite to require competition on material items and must state the quality and quantity of work required. The specifications may include requirements for a particular item, function, performance, criteria by which bids will be analyzed and reviewed for recommendation of acceptance and may, if the statute allows, contain a statement the contract will be awarded in the best interest of the governing body. A patented article or process may be specified;[34] and, in the absence of bad faith, the motive of the governing body in placing a restrictive specification will not be questioned.[35]

**2. Public Notice**

Generally, most jurisdictions require public notice sufficiently in advance of bid opening to permit potential bidders to prepare and submit their bids in a timely manner.[36] Jurisdictions may require, as a minimum, the mailing of the Invitation for Bids to all parties and any applicable bidders mailing list as well as publication in a newspaper of general circulation for a specified length of time.[37] If a particular mode of advertising of bids is specified, that mode must be substantially followed.

**3. Changes in Specifications**

Generally, upon due notice and advertisement,[38] specifications may be modified prior to the time bids are received and opened.[39] However, changes in the specifications made after the bids have been received render the contract invalid. Some jurisdictions may require the governing body to give notice to all prospective bidders known to have received an Invitation for Bids and require that the bidder acknowledge receipt of the changes.[40] The distribution should allow potential bidders a reasonable time to consider the changes while preparing their bids.[41]

Changes in specifications should be issued if the change is substantial. A change is substantial if it gives a bidder a substantial advantage or

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[32] MODEL PROCUREMENT CODE § 4-101.
[33] City of New York Procurement Policy Bd. Rules § 5-01(b)(2).
[34] MODEL PROCUREMENT CODE, RECOMMENDED REGULATIONS at R4-202.02(b). *See also* 41 C.F.R. § 5A-1.307 (allowing brand names in federal government specification).
[35] McQuillin Mun. Corp. at § 29.38.
[36] MODEL PROCUREMENT CODE § 3-202(3).
[37] ARIZ. REV. STAT. ANN. § 42-2533 (West 1992); IND. CODE ANN. § 4.13.4-5-10 (Burns Supp. 1994).
[38] THE MODEL PROCUREMENT CODE, RECOMMENDED REGULATIONS at R3-202.09.
[39] McQuillin Mun. Corp. at § 29.64.
[40] THE MODEL PROCUREMENT CODE, RECOMMENDED REGULATIONS at R3-202.09.
[41] *Id.*

benefit not enjoyed by other bidders or materially changes the character of the project.[42] A change may also be considered substantial if lack of notice of the change would prejudice some of the bidders.[43]

## E. Bid Security Performance and Payment Bonds

Bidders are frequently required to submit with their bids various forms of security to assure that they will enter into and meet the specifications of the contract.[44] For example, bid bonds or guarantee of surety certificates may be required as bid security and performance bonds or performance and payment bonds may be required to secure contract performance. Some jurisdictions may require performance and payment bonds since materialman's liens may not be permitted on public contracts.[45] The failure of a successful bidder to post a performance bond may constitute a material breach of the contract.[46] Some jurisdictions may also treat a bidder's failure to submit required bid security as a nonwaivable defect in the bid.[47]

Generally two types of bonds must be provided to the governing body. The first type of bond is a payment bond which assures that laborers, subcontractors and materialmen who contribute work and materials to the job will be paid.[48] As a result, the governing body is protected from mechanics' liens being filed against the project because the contractor did not pay his suppliers.

The second type of bond is a performance bond which assures the governing body that the bonding company will hire replacements to complete performance if the original contractor is or becomes unable to complete the project.[49] Consequently, the governing body is assured the project will be completed should the original contractor default.

## F. Withdrawal, Modification, and Mistake in Bid

A bidder may withdraw the bid and have the security returned when the bidder establishes the following:[50]

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[42] Sinram-Mamis Oil Co. v. New York, 542 N.E.2d 337 (N.Y. Ct. App. 1989).
[43] THE MODEL PROCUREMENT CODE, RECOMMENDED REGULATIONS at R3-202.10.
[44] McQuillin Mun. Corp. at § 29.66.
[45] Birmingham v. Cochrane Roofing, 547 So. 2d 1159 (Ala. 1988).
[46] Bildock, Inc. v. Chicago Hous. Auth., 714 F. Supp. 317 (N.D. Ill. 1989).
[47] Meadowbrook Carting Co. v. Borough of Island Heights, 650 A.2d 748 (N.J. 1994). However, certain courts appear not to accept the view adopted in *Meadowbrook*. *See, e.g., In re* Superior Hydraulic, Inc. v. Town Board of Islip, 453 N.Y.S.2d 711 (1982); Frank Nowak Constr. Co. v. County of Suffolk, 233 N.Y.S.2d 627 (N.Y. 1962).
[48] RICHARD E. SPEIDEL ET AL., SECURED TRANSACTIONS ch. 5(C) 273-74 (5th ed. 1993).
[49] *Id.*
[50] Travis v. Borough of Highlands, 55 A.2d 109 (N.J. 1947).

1. A mistake was made in the bid which was a honest one;
2. The mistake was of a substantial nature;
3. Compelling the bidder to perform would be unconscionable;
4. The mistake must not be the result of culpable negligence;
5. The bidder must act diligently after discovering the mistake; and
6. The bid must be withdrawn prior to the award of the contract and prior to the owner acting or relying upon the bid.

Generally, modification or withdrawal of a bid is allowed where there is a mistake of fact and the bidder has given timely notice of the mistake before bid acceptance.[51] Once performance on the contract has begun, a contractor may not modify or rescind its bid.

A bidder may be allowed to withdraw or modify a bid if a mistake of fact has been made in preparing the bid.[52] This includes such things as clerical errors and erroneous assumptions regarding the subject matter of the contract like mistaken addition or multiplication of figures, misreading of blueprints, non-negligent omission of bid terms, mistaken transposition of figures, and misunderstanding of the location or extent of work required.[53] Mistake of fact does *not* include poor judgment including the inaccurate prediction of future variables like weather conditions and cost of goods necessary for use in performing the contract.[54] If withdrawal or modification is permitted the reasons should be documented in the minutes of the governing body.

Some jurisdictions may allow the bidder to modify its bid prior to the time and date set for bid opening.[55] A bidder should, however, ensure it has complied with all formal statutory requirements[56] when modifying its bid or the courts may not permit modification, only withdrawal of the bid.[57]

## IV. Bid Opening and Bid Evaluation

### A. Generally

Upon receipt, each bid and modification should be time and date stamped but not opened.[58] Bids and modifications should be opened publicly and the amount of the bid announced at the time, date and place

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[51] McQuillin Mun. Corp. at § 29.67.
[52] *Id.*
[53] *Id.*
[54] *Id.*
[55] Model Procurement Code, Recommended Regulations at R3-202.10; Md. Regs. Code tit. 21.05.02.10B (1986).
[56] City of New York Procurement Policy Bd. Rules § 3-02(j)(1).
[57] J. L. Manta, Inc. v. Braun, 393 N.W.2d 490 (Minn. 1986) (rejecting a de minimis alteration where alteration was not made in the statutorily required manner).
[58] City of New York Procurement Policy Bd. Rules § 3-02(l)(1).

designated in the Invitation for Bids. All charter and statutory provisions controlling the opening of the bids, as well as the provisions in the advertisement, should be strictly followed since such provisions may be mandatory.[59] A failure to comply, at least substantially, with the provisions may invalidate the contract.[60] The deadline set for the submission of bids should be strictly adhered to, and bids received after the deadline should be returned to the bidder unopened.[61]

Generally, the governing body may (1) award the contract; or (2) reject all bids received, fix a new date for receiving bids, and order publication of notice to bidders.[62]

## B. Lowest Responsible and Responsive Bidder

Most jurisdictions require the governing body to award the contract to the "lowest responsible and responsive bidder."[63] A responsible bidder is one "who has the capability to perform the contract requirements and the integrity and reliability which will assure good faith performance."[64] A responsive bidder is one "who has submitted a bid which conforms in all material respects to the Invitation for Bids."[65]

Often, governing bodies are given wide discretion in awarding the contract to the "lowest responsible bidder." Factors which the governing body may consider are:

1. availability of or the ability to obtain the appropriate financial, material, equipment, facility, and personnel;[66]
2. satisfactory record of performance and integrity;[67]
3. legal qualification to contract with the governing body;[68] and
4. supplying of all necessary information regarding any inquiry into responsibility.[69]

In some jurisdictions, the determination may include an evaluation of compliance with affirmative action hiring requirements that are part of the project.[70]

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[59] McQuillin Mun. Corp. at § 29.70.

[60] C. R. Kirby Contractors, Inc. v. Lake Charles, 606 So. 2d 952 (La. App. 1992).

[61] *E.g.*, Md. State Fin. & Proc. Code Ann. § 13-209(2) (1995).

[62] *See generally* Iowa Code § 384.100 (1995); City of New York Procurement Policy Bd. Rules § 3-02(o)(1), (v)-(x).

[63] *See, e.g.*, Ariz. Rev. Stat. Ann. § 41-2533(g) (West 1992); Iowa Code § 384.99 (1995).

[64] Ariz. Rev. Stat. Ann. § 41-2531(14) (West Supp. 1994).

[65] Model Procurement Code, Recommended Regulations at R3-202.14.2.

[66] *Id.* at R3-401.01.1(a). *See* State v. Weisz & Sons, 713 P.2d 176 (Wyo. 1986).

[67] *Id.* at R3-401.01.1(b). *See* Calanan Ind., Inc. v. City of Schnectady, 498 N.Y.S.2d 490 (S. Ct. 1986).

[68] *Id.* at R3-401.01.1(d).

[69] *Id.* at R3-401.01.1(e).

[70] Association Gen. Contractors v. City of San Francisco, 619 F. Supp. 334 (N.D. Cal. 1985) (finding a five percent bidding preference for minorities constitutional).

Courts will generally only inquire into the governing body's decision to determine if the process was tainted by improper influence, fraud, or gross negligence in arriving at the decision.[71]

> [U]nless a plaintiff can demonstrate improper influence or a fraudulent scheme to eliminate fair competition, the honest exercise of discretion is presumed proper since . . . the [state] legislature passed the Competitive Bid Law *not* for the benefit of the unsuccessful bidder, but for the protection of the public.[72]

If the governing body finds the lowest dollar bidder nonresponsible, a written determination stating the basis for the finding should be prepared and made part of the governing body's minutes of the meeting when the action is taken to reject the bid.[73] Courts ordinarily will not substitute their judgment for that exercised by the governing body. However, if such a written determination is not made part of the minutes, the court may find this indicative of an arbitrary or capricious decision, not based on fact, or an abuse of discretion.[74]

## C. Preferences

### 1. Minority

A governing body may require a fixed percentage participation by minority businesses as part of the bid.[75] When a governing body, however, determines it is in their best interests to restrict submission of bids to members of a certain minority group, the Equal Protection Clause of the Federal Constitution demands strict scrutiny evaluation.[76] To determine if an ordinance constitutionally redresses the effects of past discrimination in competitive bidding, the governing body must show (1) the ordinance is carefully tailored to achieve that objective;[77] (2) substantially less intrusive alternatives are unavailable;[78] (3) the ordinance is of definite and specified duration consistent with the goals to be achieved;[79] (4) a reasonable relationship exists between the percentage

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[71] Advance Tank & Constr. Co. v. Arab Water Works, 910 F.2d 761 (11th Cir. 1990); R & A Vending Serv. Inc. v. City of Los Angeles, 218 Cal. Rptr. 667 (1985).

[72] Advance Tank & Constr. Co. v. Arab Water Works, 910 F.2d at 765.

[73] City of New York Procurement Policy Bd. Rules § 5-02(2)(h).

[74] Advance Tank & Const. Co. v. Arab Water Works, 910 F.2d at 768.

[75] Model Procurement Code §§ 11-101-301; *see also* McQuillin Mun. Corp. at § 29.47.

[76] Richmond v. J. A. Croson Co., 488 U.S. 469 (1989).

[77] *Id.* at 507.

[78] *Id.* at 507-08.

[79] South Fla. Ch. of Ass'n Gen. Contractors of Am., Inc. v. Metropolitan Dade County, Fla., 552 F. Supp. 909, 935 (S.D. Fla. 1982), *cert. denied*, 469 U.S. 871.

of minority persons to be employed and the number of minority group members in the community or in the relevant labor market;[80] and (5) the governing body must identify past discrimination in the construction industry rather than societal discrimination.[81] The ordinance must contain a waiver if the affirmative action goals cannot be met.[82] Additionally, the ordinance must not have an adverse effect on innocent potential bidders who are not members of the preferred minority group.[83]

**2. Local Preference**

As a general rule, a governing body may not select a bidder solely because the bidder is local.[84] Courts have not favored this practice because it increases the likelihood of favoritism, thereby increasing the cost to the taxpayers. However, preference may be given to material produced within the state and state domestic labor.[85] Generally, the governing body should use domestic products and provisions only when they are found in marketable quantities, are of a quality reasonably suited to the purpose intended, and don't require additional cost over foreign products or products from other states.[86]

**3. Small and Disadvantaged Businesses**

Many states have enacted statutes which give small, disadvantaged businesses assistance in learning the state's competitive bidding procedures.[87] A disadvantaged business is a small business that is "owned or controlled by a majority of persons, not limited to members of minority groups, who have been deprived of the opportunity to develop and maintain a competitive position in the economy because of social disadvantages."[88] A small business is one that is "independently owned and which is not dominant in its field of operation or an affiliate or subsidiary of a business dominant in its field of operation."[89]

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[80] *Id.*

[81] City of Richmond v. J. A. Croson Co., 488 U.S. at 498.

[82] South Fla. Ch. of Ass'n Gen. Contractors of Am., Inc. v. Metropolitan Dade County, Fla., 552 F. Supp. at 935.

[83] *Id.*

[84] Marriott Corp. v. Metropolitan Dade County, 383 So. 2d 662 (Fla. Ct. App. 1980).

[85] City of Las Vegas v. Kitchell Contractors, 768 F. Supp. 742 (D. Nev. 1991). *See also* IOWA CODE § 73.1 (1995).

[86] Iowa Op. Att'y Gen. 82-8-4 (1982).

[87] *See, e.g.*, IOWA CODE 73.15-.21 (1995); LA. REV. STAT. ANN. § 38.2233.1 (West Supp. 1995); MD. STATE FIN. & PROC. CODE ANN. § 14-301-308 (1995); THE MODEL PROCUREMENT CODE, art. 11 (1987). (Most states usually require businesses to seek certification as a small, disadvantaged business from the state. *See, e.g.*, IOWA CODE § 10A.104 (1995); LA. REV. STAT. ANN. § 38.2233.2 (West Supp. 1995); MD. STATE FIN. & PROC. CODE ANN. § 14-301 (1995).)

[88] MODEL PROCUREMENT CODE § 11-101(1).

[89] *Id.* § 11-101(2).

Occasionally assistance is given to the targeted businesses by making each agency "set aside" a portion of contracts which are competitively bid each year, soliciting the targeted business for bids on certain projects, teaching the targeted business how to do business with the state, and compiling source lists of targeted businesses.[90] These assistance programs for targeted businesses "[seek] to guard against favoritism and improvidence by prime contractors, and to increase opportunity and participation within the competitive bidding process . . . . [These] objectives are consistent with the goals of competitive bidding."[91]

## D. Nonresponsible Bidder

To reject a bidder on the ground the bidder is not "responsible," there must be evidence from which a reasonable person would believe it was not in the governing body's best interest to award the contract to the lowest bidder. Notice should be given to the bidder that specifies the reasons for the determination and the bidder should be given an opportunity to respond.[92] Some states require a hearing before the governing body to review and consider all evidence relating to the reasons for proposed disqualification.[93] The governing body's findings and conclusion should be made part of the minutes of the governing body.[94]

## E. Wages

When awarding a contract, the governing body does not have to consider whether a contractor pays prevailing wages.[95] The interests of the taxpayer are best conserved by offering contracts for public work to the competition of all persons able and willing to perform.[96] In some jurisdictions, however, governmental entities mandate the payment of prevailing rates of wage and supplemental benefits by contractors because of state law or policy.[97]

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[90] *Id.* § 11-102.

[91] Domar Elec., Inc. v. Los Angeles, 63 U.S.L.W. 2410, 2411 (Cal. Jan. 10, 1995).

[92] THE MODEL PROCUREMENT CODE § 3-401.

[93] MODEL PROCUREMENT CODE, RECOMMENDED REGULATIONS at R3-401.05, editorial note. Although a property right in a contract does not vest in a low bidder until the bid has been accepted, due process requires the low bidder be granted a hearing before awarding the contract to a bidder other than the lowest bidder. McQuillin Mun. Corp. at § 29.77; *see also* City of Inglewood v. Superior Ct. of L.A. County, 500 P.2d 601, 607 (Cal. 1972); Ward La France Truck Corp. v. City of New York, 160 N.Y.S.2d 679, 684 (N.Y. App. Div. 1957); William A. Carey & Co. v. Borough of Fairlawn, 117 A.2d 140, 146-47 (N.J. Super. Ct. App. Div. 1955).

[94] *Id.*; *see* City of New York Procurement Policy Bd. Rules § 5-02(2)(h).

[95] City of Des Moines v. Master Builders, 498 N.W.2d 702 (Iowa 1993).

[96] Miller v. City of Des Moines, 122 N.W. 226, 230 (Iowa 1909).

[97] *See* N.Y. CONST. art. I, § 17; N.Y. Labor Law § 220. These provisions apply to state agencies and to certain local governmental units as well, including municipalities such as the City of New York; N.J. STAT. ANN. § 34:11-56.25, *et seq.* (West 1990).

## F. Only One Bid Submitted

If only one bid is received which is responsive to the specifications and the statutory requirements have been followed in all respects, the contract may be awarded to the single bidder.[98] If all persons have been given an opportunity to participate as bidders, actual competition in bidding is not necessary.[99] The governing body, however, may reject the bid and: (1) solicit new bids; (2) cancel the proposed project; or (3) conduct an emergency procurement if the one bid received is not fair or reasonable and there is insufficient time for resolicitation.[100]

## G. Item Not Subject to Exact Specification

Occasionally items the governing body seeks fail to completely meet their requirements. In this event, the governing body should consider the quality and utility of the item offered as well as the adaptability to the purpose for which it is required when determining the lowest responsible bidder.[101]

## H. Bids Inadvertently Not Opened

If a bid is properly submitted but not opened because of inadvertence on the part of the governing body, the bid must be considered since all bids that comply with the advertisement must be considered.[102]

## I. Low Tie Bids

Low tie bids are bids which "are low responsive bids from responsible bidders that are identical in price and which meet all the requirements and criteria [contained] in the Invitation for Bids."[103] In this event, the governing body is given wide discretion in awarding the contract so long as the award is made in any permissible manner that will discourage tie bids. Permissible procedures include:[104]

1. awarding the contract to a business using locally produced goods or maintaining a business in the locality;
2. awarding the contract to the bidder farthest from the point of delivery if the low tie bids include cost of delivery;

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[98] McQuillin Mun. Corp., *see also* at § 29.74; Model Procurement Code, Recommended Regulations at R3-102.03.01.

[99] State v. Schmiege, 118 N.W.2d 845 (Wis. 1963).

[100] Model Procurement Code, Recommended Regulations at R3-102.03.01(a-c).

[101] McQuillin Mun. Corp. at § 29.75.

[102] *Id.* at § 29.70.

[103] Model Procurement Code, Recommended Regulations at R3-202.15.

[104] *Id.* at cmt.

3. awarding the contract to the tie bidder who received the previous award;
4. if the statute permits, negotiating a price with a tie bidder for less than the lowest responsive bid received; or
5. if the statute permits, rejecting the low tie bids and selling to the highest bidder a contract in which the state will buy the requirements at the identical bid prices.

## J. Incomplete Bids

A complete bid is defined as "one complete in itself requiring no explanation or support from other proposals and capable of being acted on in the entire absence of other bids."[105] For example, a bid for ten percent below the lowest bid is considered an incomplete, and therefore, illegal bid.

## K. Insufficient Bids Must Be Rejected

An irregularity in the form of the bid is not a basis for its rejection but there must be substantial compliance with the proposal to warrant consideration of the bid.[106] If the irregularity is technical the bid may be accepted[107] but if it is substantial (i.e., affects the amount of the bid) the bid must be rejected since it would place bidders on an unequal footing and destroy free and fair competition.[108]

## L. Rejecting All Bids

If the governing body is authorized by statute, it may reject all bids and readvertise the project.[109] The governing body cannot reject all bids arbitrarily, capriciously or in bad faith but must give equal consideration to all bidders to avoid favoritism, abuse of discretion, and corruption.[110] Courts will generally only disturb a governing body's decision to reject all bids to prevent the arbitrary rejection of a bid. If legitimate bidders would be reluctant to bid on future projects, thereby diminishing fair competition because of the governing body's continued improprieties, the agency will not be allowed to rebid the project.[111]

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[105] Casey v. Independent County, 159 S.W. 24, 25 (Ark. 1913).
[106] McQuillin Mun. Corp. at § 29.78.
[107] P. Michelotti & Sons, Inc. v. Borough of Fair Lawn, 152 A.2d 369 (N.J. Super. Ct. App. Dir. 1959).
[108] C. R. Kirby Contractors, Inc. v. City of Lake Charles, 606 So. 2d 952 (La. App. 1992).
[109] Owen of Georgia, Inc. v. Shelby County, 648 F.2d 1084 (6th Cir. 1981).
[110] Platt Elec. Supply, Inc. v. City of Seattle, 555 P.2d 421 (Wash. App. 1976).
[111] McQuillin Mun. Corp. at § 29.77.

## V. Negotiating with Bidders

Material or substantial changes in any of the bid specification terms are not permitted unless a new advertisement giving all bidders the opportunity to bid under the new plans and specifications is published.[112] Readvertising for bids is not necessitated by a slight variance between the advertised specifications and the proposed final contract but it is necessary if there is a substantial change. A change is material or substantial if it "gives the bidder a *substantial* advantage over other bidders and thereby restricts or stifles competition."[113]

## VI. Formation of a Contract

Generally, a binding contract exists on acceptance of a bid even though there may be defective compliance with legal formalities or requirements.[114] Acceptance of a bid, however, does not necessarily create a contract unless the contract was complete on award. The successful bid duly signed and the resolution accepting the bid, passed and entered in the record, will constitute a written contract.[115] However, generally the bid documents call for execution of a contract after the bidder provides a performance bond and evidence of insurance.

Ordinarily the project architect will provide the governing body with a Standard Form 06 Agreement between owner and architect.[116]

## VII. Review of Award by Courts

Absent fraud, corruption or abuse of discretion, the governing body's determination in making the award generally will not be disturbed by the courts.[117] In addition, a disappointed bidder lacks standing to bring suit against the agency but may have standing as a citizen or taxpayer.[118] Since a contractual relationship does not exist between the unsuccessful bidder and the public body, the unsuccessful bidder may not bring suit.[119]

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[112] Iowa-Nebraska Light & Power Co. v. Villisca, 261 N.W. 425, 430 (Iowa 1935).
[113] King v. Alaska State Hous. Auth., 512 P.2d 887 (Alaska 1973).
[114] McQuillin Mun. Corp. at § 29.80.
[115] *Id.*
[116] The American Institute of Architects (14th ed. 1987).
[117] *Id.* at § 29.83. *But cf.* Pendleton Bros. v. Finance & Admin. Cabinet, 758 S.W.2d 24, 28-29 (Ky.1988) (finding in an appeal for judicial review of an administrative agency's final decision that an unsuccessful bidder on a state contract could challenge the contract award because that statutory procedures were disregarded for reasons of political patronage even absent any allegation of specific acts of fraud, collusion or dishonesty).
[118] *Id.* at § 29.83.05. *See* Elview Const. Co. v. North Scott Community Sch. Dist., 373 N.W.2d 138 (Iowa 1985).
[119] Airline Const. Co. v. Ascension Parish Sch. Bd., 568 So. 2d 1029 (La. 1990).

## VIII. Payment and Completion of Contract

Generally the agency will pay the contractor according to the terms of the contract or state statute.[120] The project architect or engineer will certify any remaining items which need completion but can be completed between acceptance and final payment. The project is completed when the contractor has substantially performed all that was specified to be performed on the project and has turned it over to the public authorities.[121] A controversy over extras, trifling defects, shortcomings discovered afterward, or delay of the formal certificate of acceptance on the project are immaterial if the contractor has done all it undertook to do.[122]

Payments on a public improvement contract are generally made on the monthly estimates of labor and material.[123] Sometimes a contracting corporation must retain a certain percentage of the monthly amount due to pay claims for material and labor used on the project.[124] Generally, this fund will be released after a statutorily prescribed number of days after the project is completed and accepted by the governing body.[125]

Some jurisdictions require a proper invoice to be submitted before payment is initiated.[126] If payment is made after the required payment date, the governing body must pay the contractor interest.[127]

## IX. Conclusion

Competitive bidding is required for the benefit of the taxpayers and not for the benefit or enrichment of the bidders.[128] The process allows for free competition among bidders and no procedure that promotes favoritism or unfairness will be tolerated.[129] All statutes and rules will be interpreted with sole reference to the public interest and the governing body members and employees must remember these rules when awarding a contract let by competitive bidding.

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[120] City of New York Procurement Policy Bd. Rules § 6-07.
[121] Daniels Lumber Co. v. Ottumwa Supply & Constr. Co., 214 N.W. 481 (Iowa 1927).
[122] *Id.*
[123] City of New York Procurement Policy Bd. Rules § 6-07.
[124] *See* Iowa Code § 573.13 (1995).
[125] *Id.*
[126] City of New York Procurement Policy Bd. Rules § 6-07.
[127] *Id.*
[128] McQuillin Mun. Corp. at § 29.29.
[129] *Id.*

# NOTES

# A FEDERAL TAX LAW PRIMER FOR SCHOOL FINANCE OFFICIALS

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## INTRODUCTION

This paper provides an overview of the basic federal tax law issues that school finance officials should be aware of when contemplating the issuance of tax-exempt obligations to finance capital projects or fund cash-flow deficits. Discussions of the tax issues are not meant to be exhaustive, nor has there been any attempt to discuss the exhaustive tax rules governing refundings. School officials should consult with qualified bond counsel or other professionals when contemplating the issuance of tax-exempt obligations.

## FEDERAL TAX LAW CONSIDERATIONS FOR TAX-EXEMPT FINANCINGS

### I. LEGISLATIVE FRAMEWORK FOR TAX EXEMPTION

#### A. Statutory Codification

Gross income does not include interest on any state or local bond, if such bond meets the registration requirements[1] and does not constitute an arbitrage bond[2] within the meaning of Section 103(a) of the Internal

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[1] I.R.C. § 149(a)(1) requires that obligations of political subdivisions be issued in registered form. *See* note 17 and accompanying text *infra*.

[2] I.R.C. § 148(a). Section 148(a) provides in pertinent part: (a) *Arbitrage bond defined.*) For purposes of section 103, the term "arbitrage bond" means any bond issued as part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly) (1) to acquire higher yielding investments, or (2) to replace funds which were used directly or indirectly to acquire higher yielding investments. For purposes of this subsection, a bond shall be treated as an arbitrage bond if the issuer intentionally uses any portion of the proceeds of the issue of which such bond is a part in a manner described in paragraph (1) or (2).

Revenue Code (the "Code").[3] The present scheme for the exclusion of interest on any state or local bond from gross income is the product of the reforms set forth in the Tax Reform Act of 1986 (the "Tax Reform Act")[4] and primarily codified in Sections 141 through 150 of the Code.

The recent United States Supreme Court case, *South Carolina v. Regan*,[5] has made it clear that Congress can subject interest on state and local bonds to federal income taxation. The Supreme Court, in *South Carolina v. Regan*, upheld the validity of federal legislation which provided that the federal income tax exemption for interest earned on publicly offered long-term bonds issued by state and local governments was not exempt from taxation unless those bonds are issued in registered form. Prior to the decision in *South Carolina v. Regan*, state and local governments argued that the exclusion of interest on state or local bonds from federal taxation was protected by the Tenth Amendment[6] to the Constitution of the United States and related constitutional principles of federalism.[7] The exclusion of interest on any state or local bond from gross income is now outside the constitutional theater and has become primarily a political matter.

The statutory exemption of the exclusion of interest from gross income provided by Section 103(a) was designed to aide in the flotation of government bonds and securities by making them tax free and, therefore, more attractive to investors. With the nation's huge budget deficit problems and the current political climate dictating that the deficit must be decreased without imposing new taxes, the trend on curtailing the use by state and local governments of tax-exempt financing is likely to continue given the perception that restrictions in this area are not taxes. Since the enactment of the Tax Reform Act, the provisions affecting tax-ex-

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[3] I.R.C. § 103. Section 103 provides: Interest on State and Local Bonds. (a) *Exclusion.*) Except as provided in subsection (b), gross income does not include interest on any State or local bond. (b) *Exceptions.*) Subsection (a) shall not apply to: (1) *Private activity bond which is not a qualified bond.*) Any private activity bond which is not a qualified bond (within the meaning of section 141). (2) *Arbitrage bond.*) Any arbitrage bond (within the meaning of section 148). (3) *Bond not in registered form, etc.*) Any bond unless such bond meets the applicable requirements of section 149. (c) *Definitions.*) For purposes of this section and part IV) (1) *State or local bond.*) The term "State or local bond" means an obligation of a State or political subdivision thereof. (2) *State.*) The term "State" includes the District of Columbia and any possession of the United States.

[4] Tax Reform Act of 1986, Pub. L. No. 99-514.

[5] South Carolina v. Regan, 465 U.S. 367 (1984).

[6] The Tenth Amendment provides that "...powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively..." U.S. Const. amend. X.

[7] Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895), held that any interest earned on a state bond was immune from federal taxation. The doctrine of intergovernmental tax immunity was firmly established by the decision.

empt bonds have been further refined and regulated by federal legislation.[8]

### B. Treasury Regulations and Rulings

The Secretary of the Treasury has been given authority to prescribe such regulations as may be necessary to carry out the purposes of the Code.[9] Refinements to, and interpretations of, the Code are set forth in published regulations and rulings by the Department of the Treasury. Governmental entities can expect to see the Department of the Treasury, through the Internal Revenue Service, get more involved in monitoring and reviewing tax-exempt bond issues, especially in those areas where there are perceived abuses.[10]

## II. Interest on State and Local Bonds

Section 103 of the Code is the source for the exclusion from gross income of interest on state or local obligations.[11] "The term 'state or local bond' means an obligation of a State or political subdivision thereof."[12] In order for an "obligation" to exist for purposes of Section 103, it must be incurred pursuant to the political subdivision's power to borrow.[13]

The political subdivision must have entered into a written obligation to repay the borrowed money. The written contract must include an obligation to pay interest in order for it to be tax-exempt.[14] Financing structures which provide for issuance of certificates of participation in lease payments to be paid by political subdivisions must specifically designate in the lease what portion of the lease payment constitutes principal and interest.

Monies borrowed by the political subdivision must be available for governmental purposes otherwise there is not an obligation for purposes of Section 103.[15]

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[8] *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647; Revenue Reconciliation Act of 1989, Pub. L. No. 101-239; and Revenue Reconciliation Act of 1990, Pub. L. No. 101-508.

[9] *See* I.R.C. § 148(1). Section 148(1) provides in pertinent part, "The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section." *See also* I.R.C. 149(d)(7).

[10] *See* note 118 and accompanying text *infra*.

[11] *See* note 3 *supra*.

[12] I.R.C. § 103(c)(1). *See* note 3 *supra*.

[13] *See* United States Trust Co. of N.Y. v. Anderson, 65 F.2d 575 (2d Cir. 1933) (interest paid on condemnation award not tax-exempt).

[14] Newlin Mach. Corp. v. Commissioner, 28 T.C. 837 (1957) (an obligation must be evidenced by some type of written agreement).

[15] *See* Rev. Rul. 74-113, 1974-1 C.B. 31 (borrowed funds placed in an escrow account were not subject to invasion by the political subdivision for public uses).

Bonds issued by political subdivisions must be issued in accordance with local procedures and substantive rules. Obligations of a political subdivision which fail to satisfy procedural or substantive requirements of local law are not "obligations" within the meaning of Section 103.[16]

## III. Rules Applicable to All Tax-Exempt Bonds

### A. Registration

Generally, in order for political subdivision obligations to be tax-exempt, they must be issued in registered form, which includes book-entry-only obligations.[17] A "registered" bond means a bond, the ownership of which is recorded on registration books maintained by the bond registrar, which may be either the bond trustee or the political subdivision, and which may be only transferred through the bond registrar.

Most issuers of tax-exempt obligations issue their bonds in book-entry-only form. With book-entry-only obligations, issuers authorize the deposit at a depository, most commonly The Depository Trust Co. ("DTC"), of a single global certificate for each maturity of an issue. The elimination of printed bonds has saved issuers printing, issuance and ongoing transfer expenses. Today's sophisticated investors are quite comfortable with the idea of not receiving printed obligations.

With book-entry-only bonds, ownership positions and transactions in the obligations are initially reflected on the records of the depository and thereafter in the records of participating banks. The registration books maintained by the bond registrar would indicate who the registered owner is for the bonds, which is typically Cede & Co., the registered owner for DTC.

Registered bonds are to be contrasted with bearer bonds with respect to which no ownership records are maintained by the bond registrar and which are simply paid upon proper presentment of an interest coupon or the bond to the political subdivision or the bond registrar. The registration requirement of Section 149(a)(1) of the Code has effectively stopped the use of obligations being issued as bearer bonds with interest coupons. Congress, in requiring political subdivisions to issue their bonds in registered form, believed that usage of bearer obligations enabled taxpayers to evade income taxes.

> The Committee believes that a fair and efficient system of information reporting and withholding cannot be achieved with respect to interest-bearing obligations as

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[16] *See* Rev. Rul. 87-116, 1987-2 C.B. 44 (issuer's bonds are not obligations because it failed to get required voter approval prior to the issuance of the bonds).

[17] I.R.C. § 149(a)(1).

> long as a significant volume of long-term bearer instruments is issued. A system of book-entry registration will preserve the liquidity of obligations while requiring the creation of ownership records that can produce useful information reports with respect to both the payment of interest and the sale of obligations prior to maturity through brokers. Furthermore, registration will reduce the ability of noncompliant taxpayers to conceal income and property from the reach of the income, estate, and gift taxes. Finally, the registration requirement may reduce the volume of readily negotiable substitutes for cash available to persons engaged in illegal activities.[19]

Exceptions to the registration requirements of Section 149(a)(1) exist for obligations which are either privately placed, have a maturity of one year or less, are sold only to individuals who are not residents of the United States or the interest on the obligation is payable only outside the United States and its possessions.

## B. Information Reporting

Code Section 149(e) provides that an issuer must timely file certain information with respect to a bond issue with the Internal Revenue Service in order that the bond issue be tax-exempt.[20] A bond issue satisfies

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[19] Tax Equity and Fiscal Responsibility Act of 1982, Senate Report at 242, Conference Report at 564.

[20] I.R.C. § 149(e). Section 149(e) provides in pertinent part: (e) *Information reporting.*) (1) *In general.*) Nothing in section 103(a) or any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond unless such bond satisfies the requirements of paragraph (2). (2) *Information reporting requirements.*) A bond satisfies the requirements of this paragraph if the issuer submits to the Secretary, not later than the 15th day of the 2nd calendar month after the close of the calendar quarter in which the bond is issued (or such later time as the Secretary may prescribe with respect to any portion of the statement), a statement concerning the issue of which the bond is a part which contains) (A) the name and address of the issuer, (B) the date of issue, the amount of net proceeds of the issue, the stated interest rate, term, and face amount of each bond which is part of the issue, the amount of issuance costs of the issue, and the amount of reserves of the issue, (C) where required, the name of the applicable elected representative who approved the issue, or a description of the voter referendum by which the issue was approved, (D) the name, address, and employer identification number of) (i) each initial principal user of any facility provided with the proceeds of the issue, (ii) the common parent of any affiliated group of corporations (within the meaning of section 1504(a)) of which such initial principal user is a member, and (iii) if the issue is treated as a separate issue under section 144(a)(6)(A), any person treated as a principal user under section 144(a)(6)(B), (E) a description of any property to be financed from the proceeds of the issue, (F) a certification by a State official designated by State law (or, where there is no such official, the Governor) that the bond meets the requirements of section 146 (relating to cap on private activity bonds), if applicable, and (G) such other information as the Secretary may require.

the requirements of Section 149(e) if the issuer submits to the Internal Revenue Service, not later than the fifteenth day of the second calendar month after the close of the calendar quarter in which the bond is issued a completed Internal Revenue Service Form 8038-G. Information provided by issuers on Form 8038-G will allow the Internal Revenue Service to categorize types of municipal financings for purposes of conducting its random audit program.[20] If an issuer fails to file its Form 8038-G, it may apply to the Internal Revenue Service for an extension of time for the filing, provided that its failure to file was not due to willful neglect.[21]

## IV. Arbitrage, Reasonable Expectations, Temporary Periods and Rebate

### A. Arbitrage

Whenever the investment rate of return on issuer obligations is expected to be higher than the interest on the obligations, the issuer has to be concerned about potential "arbitrage" and compliance with the Code. Depending upon the disparity between the taxable and tax-exempt yield curves and the period of time proceeds of tax-exempt obligations are to be invested, an issuer which invests the proceeds of tax-exempt obligations in higher yielding taxable obligations may have an opportunity to profit from the differential in the yield curve.

Section 148 of the Code restricts the direct and indirect investment of bond proceeds in higher yielding investments or replacing funds which are to be used to acquire higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States.[22] The arbitrage rules are designed to minimize the arbitrage benefits of investing proceeds of tax-exempt obligations and replaced proceeds in higher yielding investments, and to remove the arbitrage incentives of issuing bonds too early, issuing more bonds than are needed for the projects to be financed, or leaving bonds outstanding longer than is

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[20] *See* note 118 and accompanying text *infra*.

[21] I.R.C. § 149(e)(3).

[22] I.R.C. § 148(f). Section 148(f) provides in pertinent part: (f) *Required rebate to the United States.*) (1) *In general.*) A bond which is part of an issue shall be treated as an arbitrage bond if the requirements of paragraphs (2) and (3) are not met with respect to such issue. The preceding sentence shall not apply to any qualified veterans' mortgage bond. (2) *Rebate to United States.*) An issue shall be treated as meeting the requirements of this paragraph only if an amount equal to the sum of) (A) the excess of) (i) the amount earned on all nonpurpose investments (other than investments attributable to an excess described in this subparagraph), over (ii) the amount which would have been earned if such nonpurpose investments were invested at a rate equal to the yield on the issue, plus (B) any income attributable to the excess described in subparagraph (A), is paid to the United States by the issuer in accordance with the requirements of paragraph (3).

otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued.[27]

Generally, unless entitled to a temporary period, proceeds of an issue must be invested at a yield not "materially higher" than the yield on the bonds. When calculating yield, whether on a bond issue or investments acquired with proceeds of the issue, the discount rate used is that which makes the present value of the expected payments of principal of and interest on the bonds (or investments) equal to its purchase price. To permit appropriate comparison, the same methods and compounding intervals must be used in calculating the yield on the investments and the bonds.

Violation of the Section 148 arbitrage provisions causes the issuer's bonds to become "arbitrage bonds," the interest on which is not excludable from the gross income of the owners of such bonds.

## B. Reasonable Expectations

The determination of whether an issue consists of arbitrage bonds under Code Section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.[28]

## C. No Arbitrage Certification

Each issue of municipal obligations must be accompanied by a nonarbitrage certificate signed by an officer of the issuer responsible for issuing the bonds who must certify as to facts and circumstances that form the basis for the issuer's expectations regarding the amount, timing, use and investment of gross proceeds. The officer signing the no arbitrage certification should have knowledge of the expected amount, timing and purpose of expenditures of the bond proceeds, the anticipated investment of bond proceeds, the source and timing of payment of the principal of and interest on the bonds and the existence of any funds which may be expected to secure or pay the bonds.

The issuer's no arbitrage certification is merely evidence of the issuer's expectations at the date of issuance, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.[29] Factors relevant to a determination of reasonableness include the issuer's history of conduct concerning stated expectations made in connection with the bond issue, the level of inquiry by the issuer into factual matters and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations.[29]

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[27] Treas. Reg. § 1.148-0(a)
[28] Treas. Reg. § 1.148-2(b)
[29] *Id.*
[29] Treas. Reg. § 1.148-1(b)

## D. Effect of Failure to Comply

A violation of the arbitrage rules may result in the interest on the bond issue becoming taxable, retroactive to the date of the issue. For example, if after the expiration of an allowable temporary period the bond issuer continued to invest proceeds of the bonds at a materially higher yield in order to earn impermissible arbitrage, interest on the bonds would become taxable, retroactive to the date of issue.

In order to ensure compliance with the arbitrage rules, issuers need to develop a post bond closing compliance program which specifically monitors the expenditure and investment of bond proceeds.

Inadvertent or insubstantial errors in the investment of proceeds of a bond issue should not cause the bonds to become arbitrage bonds.[27] However, if the issuer intentionally uses any portion of the proceeds of a bond issue to acquire higher yielding investments or to replace funds which are to be used directly or indirectly to acquire higher yielding investments, then such bonds will be treated as an arbitrage bond.[28]

The reasonable expectations test will not prevent the bonds from being arbitrage bonds, if subsequent to the date of issuance of bonds the issuer intentionally acts to earn arbitrage.[29] Additionally, a certification that is given in bad faith will not prevent a bond from being an arbitrage bond, notwithstanding reasonable expectations to the contrary.[30] For example, an issuer certifies that it expects to expend the proceeds of bonds within the three-year temporary period. The likelihood of completion of the project as contemplated is remote. The issuer's certification is issued in "bad faith" and cannot be relied upon. If the proceeds were invested in obligations with a yield materially above the bond yield, the bond is a taxable arbitrage bond. Issuers of tax-exempt bonds must comply with the arbitrage rules throughout the term of the bond issue.

Some amount of arbitrage investment earnings are inevitable in connection with almost any municipal bond issue. This occurs because the bond proceeds are not spent immediately. For example, the proceeds of an issue to finance a new school may be invested for a few years until actually dispersed for bricks and mortar. Since the obligation to pay interest on the principal amount of the bonds continues from the date of issue, an issuer wants to optimize the investment yield on bond proceeds in order to avoid any negative spread between the interest rate on the bonds and the investment return on the unspent bond proceeds. Any negative spread incurred by the issuer will only increase the total cost of the

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[27] Treas. Reg. § 1.148-2(a).
[28] *See* note 2 *supra*.
[29] *See* Rev. Rul. 80-91, 1980-1 C.B. 29, and Rev. Rul. 80-188, 1980-2 C.B. 47.
[30] *See* Rev. Rul. 88-182, 1985-2 C.B. 39.

borrowing. The temporary period rules set forth situations in which the bond proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing tax-exempt bonds to become arbitrage bonds.

## E. Temporary Periods

### 1. General

The temporary period rules establish safe harbor periods during which an issuer may invest the proceeds of its bond issue in higher yielding investments without causing the bonds to be arbitrage bonds. Maximization of investment yield on bond proceeds during a temporary period will potentially enable issuers to avoid or reduce negative investment spread on proceeds used to fund reserve or construction funds.

### 2. Construction Fund Proceeds

The Treasury Regulations provide that the "net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of three years beginning on the issue date."[31] This rule is commonly referred to as the "three-year temporary period." The three-year temporary period applies only if the issuer reasonably expects to satisfy certain rules relating to the expenditure of bond proceeds (the "expenditure test"), the timing of such expenditures (the "time test") and agrees to proceed with due diligence (the "due diligence test"). The issuer establishes its reasonable expectations through execution of a no arbitrage certificate.

The expenditure test is met if the issuer reasonably expects to expend eighty-five percent of the net sale bond proceeds on capital expenditures within three years of the date of issue.[32]

The issuer satisfies the time test if it incurs within six months of the issue date a substantial binding obligation to a third party to expend at least five percent of the net sale bond proceeds on capital projects.[33] Obligations which are subject to contingencies within the issuer's or a related party's control are not considered binding.[34]

The due diligence test is met if the issuer proceeds with due diligence to expend bond proceeds on the completion of the capital projects.[35] The Internal Revenue Service has declared that the due diligence test was not met in a situation where the issuer issued bonds twenty months

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[31] Treas. Reg. § 1.148-2(e)(2).
[32] Treas. Reg. § 1.148-2(e)(2)(A).
[33] Treas. Reg. § 1.148-2(e)(2)(B).
[34] *Id.*
[35] Treas. Reg. § 1.148-2(e)(2)(C).

prior to the date on which construction of the project was to begin and prior to that issuer's normal financial practices.[56]

The arbitrage rules are designed to prevent issuers from issuing tax-exempt bonds earlier than what is necessary for the purposes of the issuer. Tax-exempt bonds which are issued earlier than necessary to take advantage of a large interest rate spread between taxable and tax-exempt obligations in order to generate cash income constitute arbitrage bonds. In determining whether due diligence has been exercised, legal, financial, engineering or other obstacles preventing the issuer from engaging in work on the project will ordinarily be taken into account.[57] Under certain circumstances, if bonds are issued prematurely to avoid requirements of new federal, state or local laws or to earn additional arbitrage profits or for other reasons not consistent with ordinary financial practice, then the exception for temporary period investment is not available.

The three-year temporary rule allows an issuer to earn an unlimited investment yield on its bond proceeds. The value of this exception is substantially mitigated by the imposition of the new rebate rules.[58] In most instances, an issuer would not get any advantage from the early issuance of tax-exempt bonds because the rebate rules require the issuer to rebate positive arbitrage earnings to the federal government. At the end of the three-year temporary period, the issuer will be required to yield restrict its investment of bond proceeds at the yield on the bonds plus one-eighth.

Under some circumstances, capital projects which have a construction period longer than three years may qualify for a five-year temporary period.[59] To qualify for the five-year temporary period, an issuer must not only certify to the expenditure test, the time test and the due diligence test, but both the issuer and a licensed architect or engineer must certify that the longer period is necessary to complete the capital project.

**3. Reserve Funds**

Reasonably required reserve fund amounts may be invested without any yield limitations. An issue of bonds shall not be treated as arbitrage bonds solely by reason of the fact that a portion of the bonds may be invested in higher yielding investments which are part of a reasonably required reserve or replacement fund, provided the amount invested as a reasonably required reserve fund does not exceed ten percent of the pro-

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[56] Rev. Rul. 80-204, 1980-2 C.B. 51 (bonds issued prior to completion of the issuer's planning process)

[57] *Id.*

[58] *See* notes 52 and 58 and accompanying text *infra*.

[59] Treas. Reg. § 1.148-2(e)(3).

ceeds of the tax-exempt bond issue unless the issuer has established with the Secretary of the Treasury that a higher amount is necessary.[40] In order to be "reasonably required," a reserve fund must be a vital factor in marketing the bonds.[41] The requirement that the reserve or replacement fund be "reasonably required" applies to both original bond proceeds and accumulations, if any, of investment proceeds in the reserve.[42] In financings where the proceeds of the bonds are used to finance a "reasonably required" reserve, bond counsel will require that the underwriter or financial adviser certify that the reserve fund was a vital factor in marketing the bonds.

The amount of bond proceeds that may be used to fund a "reasonably required" reserve or replacement fund may not exceed an amount equal to the lesser of (a) the maximum annual principal and interest requirements on the bond issue, (b) 125% of the average annual principal and interest requirements on the bond issue, or (c) 10% of the stated principal amount (if the issue does not have more than a de minimus amount of original issue discount or premium).[43] If the reserve or replacement fund secures more than one issue of parity obligations pursuant to the terms of a master resolution or indenture, the size limitation may be measured on an aggregate basis.[44]

Any reserve or replacement fund which is funded with sale proceeds in excess of 10% of the stated principal amount (or issue price in certain cases) of the issue will cause the issue to be considered arbitrage bonds without regard to whether or not those sale proceeds are invested in higher yielding investments.[45] An issuer is not precluded from funding a reserve or replacement fund with funds other than sale proceeds of the issue. Amounts in a reserve or replacement fund in excess of the amount "reasonably required" are not considered part of a reasonably required reserve or replacement fund and must be yield restricted; provided such excess amounts were not funded from bond proceeds.

Reserve or replacement funds are not "reasonably required" when such funds are established in connection with an issue of general obligation bonds.[46] Exceptions may be granted where there are rare and unusual circumstances that would require such reserve or replacement funds.

Even though a reasonably required reserve may be invested in a higher yielding investment than the yield on the bonds, most issuers, except for

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[40] I.R.C. § 148(d)(1).
[41] Rev. Rul. 76-462,1976-2 C.B. 24.
[42] *Id.*
[43] Treas. Reg. § 1.148-2(f)(2)(ii).
[44] *Id.*
[45] Treas. Reg. § 1.148-2(f)(1).
[46] Rev. Proc. 84-26, 1984-1 C.B. 468.

issuers who qualify for a small issuer rebate exception,[47] will be required to rebate the positive arbitrage generated by this investment to the federal government.

Issuers need to establish an investment policy which maximizes yield on the reserve fund, in order to avoid negative spread. Higher yields typically mean longer term investments which will probably have some type of breakage fee if an issuer needs the reserve fund proceeds prior to the maturity of the investment. A reserve fund that is constantly under water is not beneficial to an issuer and will have a negative effect on the issuer's total interest cost.

Market and rating agency factors typically drive the need for and size of a reserve fund. Issuers who do not qualify for a rebate exception should consider the potential downside effects of negative arbitrage and fund reserves from bond proceeds only if required by market forces or rating agencies.

**4. Replacement Proceeds**

Replacement proceeds qualify, except as otherwise provided, for a thirty-day temporary period beginning on the date that the amounts are first treated as replacement proceeds.[48] Generally, replacement proceeds include amounts that have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that such amounts would have been used for the governmental purpose if the proceeds of the issue were not used or were to be used for that governmental purpose.[49] For example, the mere earmarking of amounts for a governmental purpose does not in and of itself establish a sufficient nexus to cause those amounts to be replacement proceeds.

**5. Debt Service Funds**

Amounts held in a bona fide debt service fund for a bond issue qualify for a temporary period of thirteen months.[50] A bona fide debt service fund is a fund that is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year and

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[47] *See* notes 80-84 and accompanying text *infra*.

[48] Treas. Reg. § 1.148-2(e)(5)(i).

[49] Treas. Reg. § 1.148-1(c)(1). *See* Rev. Rul. 80-13, 1980-1 C.B. 27 in which an issuer proposed to issue bonds for the purpose of financing a feasibility study and at the same time planned to request state appropriations equal to the cost of the feasibility study. The issuer intended to invest and pledge the state appropriations to secure the bonds. The service held that the appropriations were subject to the arbitrage regulations as funds "replaced" by bond proceeds on the ground that the issuer could have used the appropriations for the feasibility study as an alternative to issuing bonds.

[50] Treas. Reg. § 1.148-2(e)(5)(ii).

is depleted at least once each bond year except for a reasonable carryover amount not to exceed the greater of the earnings on the fund for the immediately preceding bond year or one-twelfth of the principal and interest payments on the bond issue for the immediately preceding year.[51]

## F. Rebate

### 1. General

The fact that an issuer qualifies for a temporary period from the arbitrage yield restriction rules does not mean that an issuer gets to retain any positive arbitrage earnings on bond proceeds. Rebate, introduced first in the Deficit Reduction and Fiscal Responsibility Act of 1984 for private activity bonds, was extended to all bonds by the Tax Reform Act of 1986. Rebate requires that the investment return over the yield on the bond issue is paid over, or rebated to the U.S. Treasury. The rebate requirements for issuers of tax-exempt bonds are codified in Internal Revenue Code Section 148(f) which applies to all bonds issued after August 15, 1986, (except bonds issued by certain small governmental issuers that issue less than $5 million per year of tax-exempt obligations).[52]

As a policy matter, Section 148(f) grew out of the Congressional Treasury perception that too many tax-exempt bond issuers were "playing games" with arbitrage. The government's perception was that many issuers were either deliberately issuing bonds earlier than necessary in order to arbitrage the proceeds, maintaining larger reserve funds than needed or keeping bonds outstanding longer than necessary. Rather than tightening the regulations under existing law, the problem was addressed in the Tax Reform Act of 1986.

Compliance with the rebate requirement does not obviate the need for compliance with the yield restriction rules and, to that extent, the two rules are duplicative. The rebate requirement primarily impacts proceeds that are entitled to the temporary period. Thus, rebate has the same economic effect for issuers as yield restriction. Issuers that qualify funds for temporary periods, but are required to rebate positive arbitrage earnings, end up in the same economic position as an issuer that did not qualify for a temporary period.

### 2. Computation and Payments

Section 148(f) requires that certain earnings on nonpurpose investments allocable to the bond issue be paid to the United States to prevent the bonds from being arbitrage bonds. The arbitrage that must be rebated

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[51] Treas. Reg. § 1.148-1(b).
[52] *See* note 22 *supra*.

is based on the difference on the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.[53] As of any date of computation, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date of all payments on all nonpurpose investments.[54]

At least 90% of the rebate amount must be paid to the U.S. Treasury as of each installment computation date, with the final payment to include 100% of the rebate amount, plus in certain circumstances generally involving late payments, any income earned on the rebate amount.[55] The first rebate payment with respect to an issue must be made for a computation date that is not later than five years after the issue date.[56] Subsequent rebate installment payments must be made for a computation date that is not later than five years after the previous computation date for which a payment was made.[57] Each rebate payment must be paid no later than sixty days after the computation date to which the payment relates. The final computation date is the date that an issue is discharged. Most issuers have rebate calculations performed annually in order to avoid inadvertent expenditure of rebatable amounts and to ensure constant funding of the rebate amount.

### 3. Effect of Failure to Comply

The failure to pay the correct rebate amount when required will cause bonds to be arbitrage bonds, unless the Commissioner of Internal Revenue Service determines that the failure was not caused by willful neglect and the issuer promptly pays a penalty to the United States.[58]

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[53] Treas. Reg. § 1.148-3(a).

[54] Treas. Reg. § 1.148-3(b).

[55] I.R.C. § 1.148-(f)(3). Section 148(f)(3) provides: *Due Date of Payments Under paragraph* (2). Except to the extent provided by the Secretary, the amount which is required to be paid to the United States by the issuer shall be paid in installments which are made at least once every five years. Each installment shall be in an amount which ensures that 90% of the amount described in paragraph (2) with respect to the issue at the time payment of such installment is required will have been paid to the United States. The last installment shall be made no later than 60 days after the day on which the last bond of the issue is redeemed and shall be in an amount sufficient to pay the remaining balance of the amount described in paragraph (2) with respect to such issue. A series of issues which are redeemed during a six-month period (or such longer period as the Secretary may prescribe) shall be treated (at the election of the issuer) as [one] issue for purposes of the preceding sentence if no bond which is part of any issue in such series has a maturity of more than 270 days or is a private activity bond. In the case of a tax and revenue anticipation bond, the last installment shall not be required to be made before the date [eight] months after the date of issuance of the issue of which the bond is a part.

[56] Treas. Reg. § 1.148-3(f)(1).

[57] *Id.*

[58] Treas. Reg. § 1.148-3(h)(1).

The rules concerning the computation of the rebatable amount are very complex and technical. Although issuers may buy computer programs which can assist them in performing their own rebate calculations, the intrinsic complexity of the rules makes it difficult for an issuer to correctly compute the rebatable amount. There are a number of accounting firms and law firms which provide rebate calculation services to municipal issuers.

## G. Exceptions from Rebate

### 1. General

The Section 148(f) rebate rules have the practical effect of superseding most of the temporary period rules. Now, virtually all investments in nonpurpose obligations are subject to the rebate requirement. Because compliance with the rebate rules is costly and administratively burdensome, many issuers structure their bond issues to qualify for an exception to rebate. There are a number of statutory and regulatory created exceptions to rebate.

### 2. Reimbursement Exception

A fundamental principle of federal tax law is that if the issuer spends all of the bond proceeds without investment, then nothing is subject to rebate under Section 148(f). This result can be achieved by having an issuer reimburse itself for prior project-related expenditures made from other sources of issuer money and to allocate the proceeds of the bond issue to reimburse the issuer for such expenditures.[56] In order for bond proceeds that are allocated for the purpose of reimbursing prior expenditures to be deemed spent, such allocation must satisfy all of the following:

a. The issuer must adopt an "official intent" not later than 60 days after payment of the original expenditure. That intent may be in any reasonable form (e.g., resolution, action by an authorized official or legislation) and must contain a general description of the project and the maximum amount of obligations to be issued for the project. On the date of the intent declaration, the issuer must have a reasonable expectation that it will reimburse the expenditure with the proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project are not reasonable. Similarly, a pattern of failing to reimburse is evidence of unreasonableness.

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[56] Treas. Reg. § 1.150-2(d).

b. The reimbursement allocation must be made no later than 18 months (three years for certain small issues) after the later of (A) the date the original expenditure is paid or (B) the date the project is placed in service, but in no event more than three years after the original expenditure is paid. For certain construction issues, the reimbursement period may be five years if both the issuer and a licensed architect or engineer certify to the necessity of the longer period.

c. Generally, the expenditure must be for a capital project. Costs of issuance, certain extraordinary working capital expenditures, grants or mortgage loans may also be reimbursed.[50]

The official intent requirement and the reimbursement period requirement do not apply to costs of issuance or to an amount not in excess of the lesser of $100,000 or five percent of the proceeds of the obligation. The official intent and reimbursement period requirements also do not apply to certain preliminary expenditures not in excess of 20 percent of the aggregate issue price of the obligation. Preliminary expenditures include architectural, engineering, surveying, bond issuance or similar expenditures incurred prior to construction or acquisition of a project. Land acquisition and site preparation costs do not qualify as preliminary expenditures.

Reimbursement allocations evidencing the issuer's use of proceeds must be in writing and must be made within 30 days of the issuance of the reimbursement bond. Project descriptions are sufficient if they identify, by name and purpose, the fund from which the original expenditure is paid.

In a refunding issue, reimbursement expenditures made from the prior issue must have satisfied the reimbursement law in effect on the date of issue of the prior bonds.[51] If this is not the case, those proceeds are treated as unspent proceeds.

In order for a declaration of intent to be reasonable, it must be consistent with the issuer's budgetary and fiscal circumstances. A reimbursement of capital expenditures would not be considered reasonable, and,

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[50] *Id.*

[51] Treas. Reg. § 1.150-2(g).

therefore, not "spent" if there are other sources of money that are reasonably expected to be used, reserved or allocated on a long-term basis for the same expenditure. Blanket declarations by an issuer to reimburse all expenditures without any attempt at specificity will not be considered reasonable. Most issuers at the time they contemplate proceeding with a major capital infrastructure project will request bond counsel to prepare a reimbursement resolution to be passed by the issuer which will comply with the provisions of the Treasury Regulations.

The Regulations provide for an antiabuse rule whereby a reimbursement allocation is deemed not spent if the allocation employs an abusive arbitrage device to avoid arbitrage restrictions or to avoid rebate requirements.[42] For example, an abusive transaction occurs where the issuer of the reimbursement bonds channels the reimbursement proceeds within one year of the issuance to pay debt service on another bond or makes a deposit to a sinking fund for a bond issue. These transactions are considered abusive because they represent attempts to avoid advance refunding limitations. However, these transactions will not be considered an abuse if the reimbursement proceeds are deposited to a bona fide debt service fund, or, as of the date of issuance of prior bonds, the issuer did not reasonably expect to use the proceeds of such bonds to reimburse prior expenditures.

**3. Six-Month Exception**

The six-month spending exception to arbitrage rebate is based on the principle that issuers that spend bond proceeds within a relatively short period of time should be relived of the financial and administrative burden of paying rebate. The six-month exception of Section 148(f)(4)(B)(i) of the Code,[43] generally provides an exception from rebate if the gross

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[42] Treas. Reg. § 1.150-2(h).

[43] I.R.C. § 148(f)(4)(B). Section 148(f)(4)(B) provides in pertinent part: (B) *Temporary investments.*) Under regulations prescribed by the Secretary) (i) *In general.*) An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraph (2) if) (I) the gross proceeds of such issue are expended for the governmental purposes for which the issue was issued no later than the day which is 6 months after the date of issuance of the issue, and (II) the requirements of paragraph (2) are met with respect to amounts not required to be spent as provided in subclause (I) (other than earnings on amounts in any bona fide debt service fund). Gross proceeds which are held in a bona fide debt service fund or a reasonably required reserve or replacement fund, and gross proceeds which arise after such 6 months and which were not reasonably anticipated as of the date of issuance, shall not be considered gross proceeds for purposes of subclause (I) only. (ii) *Additional period for certain bonds.*) (I) *In general.*) In the case of an issue described in subclause (II), clause (i) shall be applied by substituting "1 year" for "6 months" each place it appears with respect to the portion of the proceeds of the issue which are not expended in accordance with clause (i) if such portion does not exceed the lesser of 5 percent of the proceeds of the issue or $100,000. (II) *Issuers to which subclause (I) applies.*) An issue is described in this subclause if no bond which is part of such issue is a private activity bond (other than a qualified 501(c)(3) bond) or a tax or revenue anticipation bond.



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proceeds of a bond issue are spent within six months of the date of issuance. This exception provides an additional six months spending period for certain de minimus amounts constituting the lesser of five percent of the issue or $100,000. For purposes of the six-month exception, gross proceeds do not include amounts in any bona fide debt service fund, reasonably required reserve or replacement fund or amounts that are not reasonably expected to be gross proceeds but become gross proceeds after the end of the six-month spending period.

For purposes of the six-month exception, proceeds used to retire principal of the bond issue (i.e., the early retirement of bonds with excess bond proceeds) are not deemed to be spent on the governmental purpose of the issue."[54] Furthermore, a refunding issue will not meet the six-month spending exception unless all amounts that become transferred proceeds of the refunding issue are spent within six months from the date of issuance of the first tax-exempt issue used to provide the project.

**4. Two-Year Exception**

Section 148(f)(4)(C) of the Code[55] provides a rebate exception for proceeds of an issue used for construction expenditures. This exception applies if the available construction proceeds of a construction issue are spent within two years of the date of issue according to a prescribed schedule of semiannual periods. The spending requirements are met if all available construction proceeds of the issue are spent in accordance with the following schedule: (i) at least 10% are spent within six months; (ii) 45% spent within one year; (iii) 75% spent within eighteen months; and (iv) 100% are spent within two years except for a narrowly defined reasonable retainage. In any event, 100% of the available construction

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[54] I.R.C. § 148(f)(4)(B)(iv).

[55] I.R.C. § 148(f)(C). Section 148(f)(C) provides in pertinent part: (C) *Exception from rebate for certain proceeds to be used to finance construction expenditures.*) (i) *In general.*) In the case of a construction issue, paragraph (2) shall not apply to the available construction proceeds of such issue if the spending requirements of clause (ii) are met. (ii) *Spending requirements.*) The spending requirements of this clause are met if at least) (I) 10 percent of the available construction proceeds of the construction issue are spent for the governmental purposes of the issue within the 6-month period beginning on the date the bonds are issued, (II) 45 percent of such proceeds are spent for such purposes within the 1-year period beginning on such date, (III) 75 percent of such proceeds are spent for such purposes within the 18-month period beginning on such date, and (IV) 100 percent of such proceeds are spent for such purposes within the 2-year period beginning on such date. (iii) *Exception for reasonable retainage.*) The spending requirement of clause (ii)(IV) shall be treated as met if) (I) such requirement would be met at the close of such 2-year period but for a reasonable retainage (not exceeding 5 percent of the available construction proceeds of the construction issue), and (II) 100 percent of the available construction proceeds of the construction issue are spent for the governmental purposes of the issue within the 3-year period beginning on the date the bonds are issued.

proceeds must actually be spent for the governmental purpose of the issue within three years.

This exception requires a detailed analysis of the issuer's budget and construction schedule. This analysis will also require a comparison of paying potential rebate versus paying a penalty in lieu of rebate. In order to take advantage of this exception, an issuer must elect at the time of original issuance to avail itself of this exception.

A bond issue is a construction issue if at least seventy-five percent of the available construction proceeds are spent for construction related expenditures which are to be owned by the governmental entity.[56] The Regulations define "construction expenditures" as capital expenditures that are properly chargeable to or may be capitalized as part of the basis of the real property or constructed personal property.[57] Construction expenditures do not include expenditures for acquisitions of land.

Certain turnkey contracts qualify as construction expenditures if the contract between the vendor and the issuer requires the vendor to build or install the property and the property has not been built or installed at the time the parties entered into the contract.[58] If the property has been partially built or installed at the time the seller and the issuer enter into the contract, expenditures that are allocated to the portion of the property already built or installed will not qualify as a construction expenditure.

Construction expenditures include "constructed personal property." Constructed personal property is tangible personal property or specially developed computer software that the issuer acquires or that the issuer builds.[59] In the case of property that the issuer acquires; the issuer must acquire the property pursuant to a purchase contract requiring the property to be specially built to the issuer's specifications, the property must be delivered to the issuer more than six months after the date the contract is entered into, and the issuer must have no reason to believe that the vendor, giving the contract ordinary priority, could have delivered the property within six months of the contract date.[70] In the case of property that the issuer builds, no more than seventy-five percent of the capitalizable amounts may be attributable to tangible personal property acquired by the issuer (such as components, raw materials and other supplies). The property must be completed more than six months after the issuer begins building it and the issuer, exercising due diligence, could not have completed the property within six months.

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[56] I.R.C. § 148(f)(4)(C)(iv).
[57] Treas. Reg. § 1.148-7(g).
[58] Treas. Reg. § 1.148-7(g)(2).
[59] Treas. Reg. § 1.148-7(g)(3).
[70] *Id.*

The Regulations provide that real property means land and improvements to land, such as buildings or other inherently permanent structures, in addition, real property includes interests in real property.[71] Examples of real property include wiring in a building, plumbing systems, central heating or air conditioning systems, pipes or ducts, elevators, escalators, paved parking areas, roads and sewage lines. Tangible personal property means any tangible property except real property and includes machinery that is not a structural component of the building.[72]

The spending schedule applies to all available construction proceeds. "Available construction proceeds" is defined as the amount equal to the sum of the issue price of the bonds, earnings on the issue price, earnings on amounts in a reasonably required reserve or replacement fund not funded from the issue, earnings on all the foregoing earnings less the amount of the issue price deposited in any reasonably required reserve or replacement fund and the issuance costs financed by the bonds.[73] Earnings on any reasonably required reserve or replacement fund are considered available construction proceeds only to the extent that those earnings accrue before the earlier of the date construction is substantially completed or the date that is two years after the issue date. Arbitrage earnings on the reserve during the two-year construction period would help to reduce the size of the bond issue. In any event, the issuer is required to rebate excess arbitrage earnings on reserve funds on the earlier of substantial completion of the project or two years from the issue date. On or before the date of issue, the issuer may elect to exclude from available construction proceeds the earnings on any reasonably required reserve or replacement fund. If this election is made, the issuer must rebate on the reserve fund from the date of issue. Most general obligation bond issues will not have reserve funds, however, for certificate of participation financings, market forces or the rating agencies may require the funding of reserve funds. Issuers that want to take advantage of the "two-year exception" need to determine in advance how to handle reserve fund earnings to avoid unintentional violation of the expenditure requirements.

If the issuer fails to meet the expenditure requirements, the proceeds of the issue are subject to rebate unless the issuer elected on or before the date of issuance to pay a penalty in lieu of rebate.[74] This penalty is imposed for each six-month period after the date of issuance and equals 1.5% times the amount of available construction proceeds which were required to be spent but were not as of the close of each six-month period

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[71] Treas. Reg. § 1.148-7(e)(3).
[72] *Id.*
[73] *See* I.R.C. § 148(f)(4)(C)(vi) and Treas. Reg. § 1.148-7(i).
[74] I.R.C. § 148(f)(4)(C)(vii).

until the bonds are no longer outstanding.[75] For each spending period, unexpended proceeds are computed by subtracting available construction proceeds spent for the governmental purpose of the issue at the end of the spending period from available construction proceeds required to be spent by the end of the spending period. The penalty ceases to apply to unspent available construction proceeds only after the bonds mature. The penalty must be paid to the United States no later than ninety days after the end of the spending period to which the penalty relates.

When all or a portion of the construction is substantially complete, the issuer may toll the running of the 1.5% penalty by paying another penalty equal to 3% of the unspent available construction proceeds not needed for the completed construction, multiplied by the number of years or portions thereof between the date of issue and the end of the temporary period.[76] As of the close of the temporary period, the unexpended amount must be invested in either tax-exempt bonds or in other yield-restricted investments. Additionally, the bonds must be called or otherwise redeemed from the unexpended amount at the earliest date the bonds may be redeemed without regard to redemption premium.[77] An issuer should consult with its bond counsel and financial adviser prior to making an election to pay penalty-in-lieu-of rebate. If there is any doubt that there may be unspent available construction proceeds or delayed projects, the issuers should not elect to pay penalty-in-lieu-of rebate.

If only a portion of a bond issue is to be spent for construction, the construction portion and the other portion or portions may be treated as separate issues for purposes of meeting the two-year expenditure exception from rebate.[78] All construction expenditures, however, must be treated as funded only from the construction portion of the bond issue. The issuer may, but is not required to, use the six-month, but not the eighteen-month, expenditure exception from rebate with respect to the other portions. For example, if less than 75% of the available construction proceeds of an issue are to be used for construction expenditures, the issuer can elect to treat the issue as two issues and have the two-year rule apply only to the construction portion (which may include nonconstruction expenditures consistent with the 75% rule). The issuer may then apply the six-month exception to the nonconstruction portion of the issue. If either or both exceptions from rebate are not met, then investment earnings on that separate portion will be subject to rebate, unless the issuer has elected penalty in lieu of rebate with respect to the two-year construction exception.

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[75] *Id.*
[76] Treas. Reg. § 1.148-7(i).
[77] *Id.*
[78] I.R.C. § 148(f)(4)(C)(v).

**5. Eighteen-Month Exception**

The eighteen-month exception is a regulatory, and not a statutory, rule which provides that if gross proceeds are allocated to expenditures for governmental purposes in accordance with a regulatory provided expenditure schedule then positive investment earnings on bond proceeds during a prescribed period (not to exceed eighteen months) are not subject to rebate.[79] The prescribed schedule is as follows: (i) 15% within six months; (ii) 60% within twelve months; and (iii) 100% within eighteen months, with a provision for a reasonable retainage similar to that of the two-year rule, but requiring expenditure within thirty months. Failure to meet the expenditure requirements means the issue is subject to rebate. Gross proceeds do not include amounts in a reasonable required reserve or replacement fund or a bona fide debt service fund. The bond issue must still qualify for an initial temporary period. Arbitrage earnings on the reserve fund are still subject to rebate after the end of the eighteen-month period.

**6. Small Issuer Exception**

Issuers of tax-exempt bonds for local governmental projects, who do not reasonably expect to issue more than $5 million of tax-exempt obligations during the calendar year of the issue, are excused from complying with the rebate rules.[80] The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers, such as school districts, the proceeds of which are to be used to finance governmental activities of the issuer. An issuer has general taxing powers if it has the power to impose taxes, or to cause another entity to impose taxes, of general applicability which, when collected, may be used for governmental activities of the issuer.[81] The taxing power may be limited to a specific type of tax, such as a sales tax, provided that the applicability of the tax is not limited to a small number of persons.[82]

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[79] Treas. Reg. § 1.148-7(d).

[80] I.R.C. § 148(f)(4)(D). Section 148(f)(4)(D) provides in pertinent part: (D) *Exception for governmental units issuing $5,000,000 or less of bonds.*) (i) *In general.*) An issue shall, for purposes of this subsection, be treated as meeting the requirements of paragraphs (2) and (3) if) (I) the issue is issued by a governmental unit with general taxing powers, (II) no bond which is part of such issue is a private activity bond, (III) 95 percent or more of the net proceeds of such issue are to be used for local governmental activities of the issuer (or of a governmental unit the jurisdiction of which is entirely within the jurisdiction of the issuer), and (IV) the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by such unit during the calendar year in which such issue is issued is not reasonably expected to exceed $5,000,000.

[81] Treas. Reg. § 1.148-8(b).

[82] *Id.*

In applying the $5 million size limitation, de minimis amounts of original issue discount or premium are not taken into account. Further, there is not taken into account the portion of an issue that is a current refunding (an issue issued no more than ninety days prior to the redemption date of the bonds to be redeemed by the issue) to the extent that the stated principal amount of the refunding bonds does not exceed the portion of the outstanding stated principal amount of the refunded bonds paid with the proceeds of the refunding bond.[53]

To the extent that an issuer participates in a pooled financing and the issuer (for example, a state-wide financing authority) of the pooled financing is not an ultimate borrower in the financing, and the participating borrowers are governmental units with general taxing powers and not subordinate to the issuer, the pooled financing is not counted toward the $5 million size limitation of the participating borrower for purposes of applying the small issuer exception to its other issues.[54] It is this exception that has enabled numerous school districts and other political subdivisions to participate in pooled tax and revenue anticipation note financings.

Qualifying for the small issuer exception means avoiding the administrative burden of rebate calculations and keeping permitted arbitrage, if any, which may lower the total interest cost of the issue.

**7. Bona Fide Debt Service Fund Exception**

Section 148(f) of the Internal Revenue Code provides that any amount earned on a bona fide debt service fund shall not be taken into account if the gross earnings on such fund for a bond year is less than $100,000.[55] For governmental bonds with an average maturity of at least five years and with a fixed rate of interest for the term of the issue, the $100,000 limit is waived and all gross earnings are excluded from the rebate requirements.

**8. Tax-Exempt Investment Exception**

Section 148(f)(6) of the Code defines the term "nonpurpose investment" as any investment property which is acquired with gross proceeds of an issue and is not acquired in order to carry out the governmental purpose of the bond issue.[56] It is "nonpurpose investments" which are the subject matter of the Section 148(f)(4) rebate requirements. Sections 148(b)(3) of the Code and Treas. Reg. § 1.148-1(b) exclude from the definition of "investment property," and thus from the definition of "nonpurpose investment," any "tax-exempt bond" or "qualified exempt

[53] Treas. Reg. § 1.148-8(c)(3).
[54] Treas. Reg. § 1.148-8(d).
[55] I.R.C. § 148(f)(4)(A)(ii).
[56] I.R.C. § 148(f)(6).

investment." Thus, issuers can invest the proceeds of a bond issue in certain higher yielding tax-exempt investments and not be subject to rebate. Seldom will issuers find a sufficient spread between the yield on its bonds and tax-exempt investment yield on another issuer's bonds to justify utilization of this exception.

Section 150(a)(6) of the Code defines a "tax-exempt bond" to be any bond or issue the interest on which is excluded from gross income. However, Section 148(b)(3)(B) excludes from the definition of "tax-exempt bond" any bond which is subject to the alternative minimum tax.[57] Bonds subject to the alternative minimum tax are nonpurpose investments for bonds not subject to the alternative minimum tax. All private activity bonds are subject to the alternative minimum tax.

**9. Yield Restriction**

Finally, for issuers who do not qualify for the small issuer exception from rebate, of general interest is the ability of all issuers to avoid rebate through the restricting of the yield on all investments of gross proceeds of a bond issue to a yield no greater than the yield on the bonds. This subjects issuers to the market price rules of Treas. Reg. § 1.148-5, which provides that issuers not buy an investment for more than fair market value or sell for less than fair market value. The federal government wants issuers to rebate positive arbitrage to the Treasury. Rebate is a revenue source to the federal government.

## V. Tax and Revenue Anticipation Notes

### A. General

Political subdivisions are often faced with the problem of coinciding their expenditures with the receipt of state funds and ad valorem taxes. For example, school district taxes are levied on October 1 and become delinquent after January 31 of the following year. Consequently, school districts may face cash shortfalls in September, October and November while experiencing cash surpluses in December, January and February.

Financing techniques known as tax anticipation notes ("TANs") and revenue anticipation notes ("RANs") provide solutions to the problems

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[57] The Tax Reform Act subjected interest on certain tax-exempt obligations to the alternative minimum tax ("AMT") imposed by Section 55 of the Internal Revenue Code. Under Section 55, an individual or a corporate taxpayer must, in addition to computing its "regular" taxable income and its corresponding "regular" tax liability, compute its "alternative minimum taxable income" ("AMTI") and its corresponding alternative minimum tax liability. Consequently, tax-exempt bonds which are subject to AMT typically have higher interest rates than traditional governmental essential function tax-exempt bonds.

created by cash shortfalls resulting from the timing of the receipt of ad valorem taxes and state funds. These are short-term notes which are issued in anticipation of receipt of taxes and revenues. The interest on TANs and RANs is excluded from gross income under Section 103(a) of the Code.

Tax-exempt financing has the inherent advantage of lowering borrowing costs due to the tax savings passed on to the investor. The net cost to the political subdivision of such an issue, depending on the amount of obligations issued and the length of time during which the issue proceeds might be invested prior to use by the political subdivision, is often minimal. TANs and RANs are considered to be a specialized version of working capital financings.

## B. Working Capital

As a general proposition under federal tax law, governmental entities may issue notes, the interest on which is excluded from gross income, to finance working capital shortfalls to the extent that those working capital expenditures exceed available amounts.[88] Working capital financings are those intended to finance working capital expenditures that are not capital expenditures but that are generally current operating expenditures. Working capital expenditures do not include payments of (a) administrative costs recovered from the permitted spread on purpose investments, (b) qualified guarantee fees, (c) qualified hedging transaction payments, (d) project-related bond interest for a period ending on the later of three years or one year after the project's placed-in-service date, (e) rebate or penalty in lieu of rebate payments, (f) principal or interest on an issue paid from unexpected excess sale or investment proceeds, (g) principal and interest on an issue from a bona fide debt service fund, (h) principal, interest or redemption premium on a prior issue, (i) interest on a crossover refunding issue, (j) working capital expenditures that are directly related to capital expenditures of less than five percent of the sale proceeds of an issue, and (k) expenditures for extraordinary, nonrecurring items not customarily payable from current revenues (e.g., casualty losses or extraordinary legal judgments in excess of reasonable insurance coverage) to the extent that an issuer does not maintain a reserve (self-insurance fund) for such items.[89]

## C. Bond-Proceeds-Spent-Last Rule

Working capital financings are unique in that bond proceeds may be allocated to expenditures only under a bond-proceeds-spent-last alloca-

[88] Treas. Reg. § 1.148-6(d)(3).
[89] *Id.*

tion mechanism that requires all other available amounts to be expended before gross proceeds (i.e., bond proceeds with some adjustments) may be allocated to expenditures.[90] Additionally, notwithstanding any of the exceptions to the definition of working capital expenditures, the bond-proceeds-spent-last allocation mechanism is required if the allocation of gross proceeds merely substitutes the gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds.[91]

## D. Available Amounts

The Regulations provide that the cash flow deficit is computed by comparing all "available amounts" with expenditures. "Available amounts" include any amounts available to the issuer for working capital expenditures including cash, investments and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer without legislative or judicial action or without a legislative, judicial or contractual requirement that those amounts be reimbursed.[92]

## E. Temporary Period

The temporary period for the proceeds of an issue reasonably expected to be allocated to working capital expenditures is thirteen months.[93] The temporary period is extendable for issues retired solely from ad valorem tax revenues to the date that is sixty days after the last date for payment of taxes without interest or penalty (with a maximum period of two years).[94]

## F. Sizing

The Regulations do not provide specific rules governing the sizing of TANs and RANs. However, the proceeds-spent-last expenditure rule of Treas. Reg. § 1.148-6(d)(3)(i) implicitly provides such a rule since oversizing a borrowing will preclude an issuer from concluding that proceeds have been spent within the allowable temporary period. Issuers need to be concerned with oversizing an issue because issues which overburden the tax-exempt market are considered arbitrage devices which may cause the bonds to be considered arbitrage bonds.[95]

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[90] Treas. Reg. § 1.148-6(d)(3)(i).
[91] Treas. Reg. § 1.148-6(d)(3)(ii)(D).
[92] Treas. Reg. § 1.148-6(d)(3)(iii).
[93] Treas. Reg. § 1.148-2(e)(3).
[94] *Id.*
[95] Treas. Reg. § 1.148-10(a).

## G. Working Capital Reserves

For purposes of determining the "available amount" which must be spent prior to bond proceeds, a reasonable working capital reserve is treated as unavailable.[96] Any working capital reserve is reasonable if it does not exceed five percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amount is made.[97] The Regulations effectively confirm that, in the context of working capital financing, "you don't have to be broke to borrow." In essence, a portion of the issuer's projected general fund revenues can be treated as a reasonable reserve and therefore unavailable. Such reserves do not need to constitute a distinct fund or funds.

While these rules allow TAN or RAN issuers to enjoy arbitrage earnings, they don't speak to whether such issuers can keep those earnings or to what extent the earnings are subject to rebate.

## H. TRAN Rebate Exceptions

### 1. Safe Harbor Exception

Section 148(f) of the Code extends the basic rebate requirements to tax and revenue anticipation notes and provides a special safe harbor rebate exception, in paragraph (4)(B)(iii), for tax and revenue anticipation notes:

> a. In general, the net proceeds of an issue of tax or revenue anticipation notes, including investment proceeds derived therefrom, will be deemed to have been fully expended, and in consequence no rebate requirement is imposed, if within six months of the date of issuance the cumulative cash-flow deficit to be financed with the proceeds of such issue exceeds 90% of the aggregate face amount of such issue;
> b. For purposes of Section 148(f)(4)(B)(iii), "cumulative cash-flow deficit" means the excess of expenses ordinarily paid or financed from anticipated tax or other revenues over the aggregate funds available (not including the proceeds of the issue). In other words, no allowance is made for a "reasonable required reserve."

### 2. Statutory Six-Month Exception

The Joint Committee on Taxation's General Explanation of the Tax Reform Act of 1986 (commonly referred to as the "Blue Book") pro-

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[96] Treas. Reg. § 1.148-6(d)(3)(iii)(B).
[97] *Id.*

vided that the issuer may alternatively establish that it has actually spent all the proceeds of the notes for governmental purposes within six months.[98] The Blue Book goes on to say that, "[f]or this purpose, ...TRAN proceeds are treated as spent only as actual cash-flow deficits arise and the note proceeds are used to offset these deficits." Thus, the cash-flow borrowing is not to provide the next dollars spent, but is to provide the increase in the cash balances, in the view of the Joint Committee.[99] Accordingly, the six-month exception is actually the same as the safe harbor, but with a higher threshold of compliance. Many funds that issuers have traditionally deemed "not available" for sizing may nonetheless count as "available" for meeting the safe harbor.[100]

**3. Small Issuer Exception**

For many issuers perhaps a better exception from rebate is the "small issuer exception" for bonds issued to finance governmental activities found in paragraph (4)(D) of Section 148(f) of the Code.[101] This exception permits avoiding rebate while sizing for the full amount of the working capital deficit, plus a "working capital reserve."

The determination as to whether an issuer qualifies for the safe harbor rebate exception or the statutory six-month expenditure exception to rebate is based on an actual determination of the issuer's deficit.

An issuer which expects to qualify for the small issuer exception from rebate will qualify whether or not it had an actual deficit equal to its projected deficit provided it did not misrepresent its expectations with respect to its projected cash-flow deficit.

If neither the safe harbor exception, the statutory six-month exception nor the small issuer exception is met, the issuer of TANs or RANs is left in the position of having to make rebate payments to the federal government in order to protect the tax-exempt status of its issue. In view of the fact that compliance with the safe harbor exception and statutory six-month exception are actual tests, whereas compliance with the small issuer exception involves a reasonable expectations test, most issuers will try to structure TANs or RANs to qualify for the small issuer exception from rebate or conservatively size issues attempting to meet either the safe harbor or six-month exceptions from rebate.

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[98] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, H.R. 3838, 99th Cong., Pub. L. No. 99-514, p. 1210, note 172.

[99] *Id.*

[100] *See supra* note 106.

[101] *See supra* notes 80-84 and accompanying text.

## VI. INVESTMENTS

Proper computation of the arbitrage yield and rebate due upon investments requires evaluation of the investments at various points in time. Generally, an investment must be valued at its "fair market value" on the date it is first allocated to an issue or ceases to be so allocated.[102] Such an allocation would include the initial purchase of an investment with bond proceeds, the sale of an investment allocated to the bond proceeds, the sale of a previously acquired investment from the account of the issuer to a bond-related account, and the deposit or pledge of previously acquired investments to a reserve fund or sinking fund. "Fair market value" of an investment on a particular date is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide arms-length transaction.[103] Fair market value is determined on the date on which a contract of purchase or sale of an investment becomes binding.

Under certain circumstances, the Regulations provide that an investment must be valued at its "present value" if (i) the investment is subject to yield restriction, (ii) the investment ceases to be allocated or becomes allocated to an issue because of the transferred proceeds allocation rule (which occurs in connection with a refunding), (iii) the investment ceases to be allocated or becomes allocated to an issue because of the universal cap rule, or (iv) the investment is in a co-mingled fund (other than a bona fide debt service fund) unless it is a co-mingled fund that operates exclusively as a reserve fund, sinking fund or replacement fund for two or more issues of the same issuer.[104] "Present value" of an investment on a particular date is equal to the present value of all unconditionally payable receipts to be received from and payments to be paid for investments after such date, using the yield on the investment at the discount rate.[105]

A plain par investment (i.e., with a de minimus amount of original issue discount) may be valued at its outstanding stated principal amount, plus accrued unpaid interest on that date.[106]

The purchase price of a guaranteed investment contract is treated as the fair market value if (a) the issuer makes a bona fide solicitation for a specified guaranteed investment contract and receives at least three bona fide bids from providers that have no material interest in the issue (e.g., as underwriters or brokers); (b) the issuer purchases the highest yielding investment contract for which a qualifying bid is made (determined net of brokers' fees); (c) the yield on the guaranteed investment contract

[102] Treas. Reg. § 1.148-5(d)(3)(i).
[103] Treas. Reg. § 1.148-5(d)(6)(i).
[104] Treas. Reg. § 1.148-5(d).
[105] Treas. Reg. § 1.148-5(d)(5).
[106] Treas. Reg. § 1.148-5(d)(i).

(determined net of brokers' fees) is not less than the then available yield from the provider on a reasonably comparable investment contract, if any, offered to other persons from a source of funds other than gross proceeds of tax-exempt bonds; (d) the determination of the terms of the guaranteed investment contract takes into account as a significant factor the issuer's reasonably expected drawdown schedule; (e) the terms of the guaranteed investment contract are reasonable; and (f) the obligor on the guaranteed investment contract certifies the administrative costs that it is paying (or expects to pay).[107] Bond counsel will require a certificate from the provider of the guaranteed investment contract stating the amount of brokers' fees paid.

Although the Treasury Regulations provide that "administrative costs" are generally not taken into account in determining (i.e., reducing) the yield on the investment, the yield on an investment is to be adjusted downward for qualified administrative costs.[108] "Qualified administrative costs" are reasonable, direct administrative costs, other than carrying costs, which include brokerage or selling commissions, but not legal, accounting, record keeping, custody and similar costs.[109] Overhead costs and indirect costs of the issuer, such as employee salaries and office expenses or costs associated with computing arbitrage rebate, are not qualified administrative costs.[110] The Regulations provide that a broker's commission paid by or on behalf of an issuer or the provider of a guaranteed investment contract is not a qualified administrative cost to the extent the commission exceeds .05% of the amount reasonably expected to be invested per year.[111] This rule does not apply if the bond issue qualifies for the small issuer exception to arbitrage rebate.

Needless to say, the valuation requirements of the Treasury Regulations are very technical requiring issuers to maintain very detailed records as to the timing, amount and nature of investments. Numerous issuers hire certified public accountants or law firms which specialize in computing rebate to do the calculations. These firms have little difficulty in computing the correct amount of rebate if the records that are provided to them are detailed.

## VII. General Allocation and Accounting Rules

Proper implementation of the arbitrage and rebate regulations requires a method by which issuers can allocate bond proceeds to particu-

[107] Treas. Reg. § 1.148-6(iii).
[108] Treas. Reg. § 1.148-5(e)(1).
[109] Treas. Reg. § 1.148-5(e)(2).
[110] *Id.*
[111] Treas. Reg. § 1.148-5(e)(2)(iii).

lar investments, and to designate when those bond proceeds are spent. The tax statutes and regulations consider bond proceeds to either be invested or spent. In its simplest terms, the direct tracing of bond proceeds to investments and to expenditures may be a viable approach for limited purpose issues or small issuers. However, for most issuers this approach is not workable. Bond proceeds may be co-mingled with other funds (including proceeds of other bond issues) to build the project or to fund the reserve fund; investment earnings may end up being co-mingled in a common revenue fund or general fund, from which the specific tracing of the expenditure of those earnings may well be impossible. Implementation of a direct tracing would require for some issuers to substantially revamp their computer software and accounting systems.

The Regulations allow issuers to use any reasonable, consistently applied accounting method to account for the investment, expenditure and all other allocations of bond proceeds.[112] The Regulations specifically allow for the allocation of the expenditure of gross proceeds of an issue under such methods as specific tracing, bond proceeds spent first, first in first out, or ratably.[113] A different accounting method required to be used to fulfill a bona fide governmental purpose may be treated as reasonable and consistent. Failure to follow general or specific accounting rules will result in an issue being taxable as an arbitrage bond.

Many accounting rules are also dictated by the Regulations. For example, amounts are to be allocated to only one issue at a time as gross proceeds, and amounts which could be proceeds of one issue and replacement proceeds of another issue, are to be allocated to the issue for which they are proceeds.[114]

Generally, bond proceeds expended for working capital expenditures will be deemed to be spent after any other available amounts, regardless of the allocation method chosen for capital expenditures and regardless of any accounting method that might be chosen for these expenditures (such as direct tracing of expenditures).[115] Issuers are required to account for all proceeds of an issue. Proceeds of an issue generally include all sale proceeds, investment proceeds and transferred proceeds (i.e., unspent proceeds of a refunded issue). There are four ways that amounts cease to be treated as proceeds of an issue: (a) upon expenditure for a governmental purpose; (b) upon allocation to another issue pursuant to the transferred proceeds rules (which occur in refundings); (c) upon retirement of an issue; and (d) upon release pursuant to the universal cap

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[112] Treas. Reg. § 1.148-6(a).
[113] Treas. Reg. § 1.148-6(d)(1)(i).
[114] Treas. Reg. § 1.148-6(b).
[115] Treas. Reg. § 1.148-6(d)(3).

rules provided for in the Regulations which limit the amount of gross proceeds allocable to an issue.

The allocation and accounting rules set forth in the Treasury Regulations will be workable for most issuers of "plain vanilla bonds," provided the issuer keeps adequate accounting records of its investments and expenditures. Issuers who are often in the bond market or have complicated financing structures and flows of revenues will find that the assistance of tax counsel or specialized accounting firms will be necessary to work through the myriad of complicated tax accounting and allocation issues.

## VIII. Bank Qualification

Section 265(b) of the Internal Revenue Code provides that a bank that purchases tax-exempt bonds after August 7, 1986, will lose the tax deduction for a pro rata amount of interest that the bank pays on its borrowings.[116] An exception is provided for banks purchasing tax-exempt bonds issued by small issuers who reasonably expect to issue no more than $10,000,000 of tax-exempt bonds for the calendar year. In adding up the $10,000,000, all tax-exempt obligations, with certain exceptions, which

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[116] I.R.C. § 265(b). Section 265(b) provides in pertinent part: (b) *Pro rata allocation of interest expense of financial institutions to tax-exempt interest.*) (1) *In general.*) In the case of a financial institution, no deduction shall be allowed for that portion of the taxpayer's interest expense which is allocable to tax-exempt interest. (2)*Allocation.*) For purposes of paragraph (1), the portion of the taxpayer's interest expense which is allocable to tax-exempt interest is an amount which bears the same ratio to such interest expense as) (A) The taxpayer's average adjusted bases (within the meaning of section 1016) of tax-exempt obligations acquired after August 7, 1986, bears to (B) such average adjusted bases for all assets of the taxpayer. (3) *Exception for certain tax-exempt obligations.*) (A) *In general.*) Any qualified tax-exempt obligation acquired after August 7, 1986, shall be treated for purposes of paragraph (2) and section 291(e)(1)(B) as if it were acquired on August 7, 1986. (B) *Qualified tax-exempt obligation.*) (i) *In general.*) For purposes of subparagraph (A), the term "qualified tax-exempt obligation" means a tax-exempt obligation) (I) which is issued after August 7, 1986, by a qualified small issuer, (II) which is not a private activity bond (as defined in section 141), and (III) which is designated by the issuer for purposes of this paragraph. (ii) *Certain bonds not treated as private activity bonds.*) For purposes of clause (i)(II), there shall not be treated as a private activity bond (I) any qualified 501(c)(3) bond (as defined in section 145), or (II) any obligation issued to refund (or which is part of a series of obligations issued to refund) an obligation issued before August 8, 1986, which was not an industrial development bond (as defined in section 103(b)(2) as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) or a private loan bond (as defined in section 103(o)(2)(A), as so in effect, but without regard to any exemption from such definition other than section 103(o)(2)(A)). (C) *Qualified small issuer.*) (i) *In general.*) For purposes of subparagraph (B), the term "qualified small issuer" means, with respect to obligations issued during any calendar year, any issuer if the reasonably anticipated amount of tax-exempt obligations (other than obligations described in clause (ii)) which will be issued by such issuer during such calendar year does not exceed $10,000,000.

the issuer and all subordinate entities to that issuer reasonably anticipate to issue during the calendar year, are aggregated and taken into account.

Issuers need to elect to comply with the provisions of Section 265(b). Thus, only an issuer that reasonably anticipates issuing $10 million or less of tax-exempt obligations for a calendar year may designate any of these obligations for purposes of qualifying for the exception. In some instances, issuers may want to downsize a bond issue in order to take advantage of bank qualification.

Bond issues which qualify under the provisions of Section 265(b) typically will have lower interest rates than bonds which do not qualify because banks are willing to purchase these bonds at lower yields.

## IX. Antiabuse Rules and Enforcement

A bond issue will be treated as arbitrage bonds under Section 148 of the Code if an "abusive arbitrage device" is used in connection with the issue. An "abusive arbitrage device" is defined as any action that has the effect of (i) enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage and (ii) overburdening the tax-exempt bond market.[117] Issuing more bonds, issuing bonds earlier or allowing bonds to remain outstanding longer than is reasonably necessary are examples of overburdening the tax-exempt market. An important factor bearing upon the determination as to whether an action constituted an "abusive arbitrage device" is whether a similar action would be taken if the interest on the issue were not excludible from gross income. A bond which is treated as an arbitrage bond will be taxable retroactive to the date of issue.

An issue that overburdens the tax-exempt bond market but which does not exploit tax-exempt interest rates is subject to special limitations, including special yield restrictions and restrictive expenditure rules.

For the first time ever, the Internal Revenue Service has initiated a program to audit state and local government issuers to ensure compliance with the Code and the Treasury Regulations.[118] The primary purpose of the audit program is regulatory and not the generation of revenue. The audit program is designed to discover and stop abusive transactions. Generally, any governmental tax-exempt bond issue completed since passage of the Tax Reform Act of 1986 (which took effect August 31, 1986) may be subject to an audit.

The program is being developed by the Exempt Organizations Technical Division ("EOTD") of the Internal Revenue Service. The EOTD

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[117] Treas. Reg. § 1.148-10(a)(2).

[118] I.R.S. Information Release, Jan. 10, 1994.

will oversee an audit program which has two parts; first, audits reacting to specific complaints (the dimed deal); and second, a systematic effort to determine base levels of compliance through random selection. The expanded examination program will use a statistical sampling of information documents to assess compliance and identify areas where Internal Revenue Service resources should be targeted.

# NOTES

# A FEDERAL SECURITIES LAW PRIMER FOR SCHOOL FINANCE OFFICIALS

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## INTRODUCTION

This paper will focus on the federal securities laws that may be encountered by school officials undertaking a capital improvement program or other project to be financed through the issuance of municipal bonds.

Part I describes the existing federal regulatory framework beginning with a brief history of its evolution. The applicable provisions of the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act") are discussed. Taken together, these Acts form the foundation of the federal securities laws. The major regulatory players–the Securities and Exchange Commission ("SEC") and the Municipal Securities Rulemaking Board ("MSRB")–are introduced. In addition, Part I discusses the SEC's current view of the disclosure obligations of municipal underwriters and issuers under the antifraud rules and the limitations placed upon the SEC by the Tower Amendment.

Part II focuses on the role of SEC Rule 15c2-12 in primary market regulation. This rule was the SEC's first major attempt to upgrade disclosure practices in the municipal securities market, and requires underwriters to review an official statement "deemed final" by an issuer in most primary offerings.

Part III addresses the SEC's recently adopted amendments to Rule 15c2-12 and proposed amendments to Rule 2a-7. The amendments to Rule 15c2-12 effectively require most municipal issuers and conduit borrowers to make routine disclosure of their financial affairs to the secondary market through a central filing process and require broker-dealers to have procedures in place to monitor any material event disclosures filed. The proposed amendments to Rule 2a-7 governing tax-exempt money market funds are also designed to improve secondary market disclosure by municipal issuers.

Part IV deals with new MSRB Rule G-37 regulating political contributions to municipal issuers. The rule was designed to eliminate "pay-to-play" practices in the municipal securities industry. Like the amendments to Rule 15c2-12, it has generated a large amount of debate among market participants.

Part V discusses how the parties to a bond issue, and in particular the issuer, go about complying with their duties under the federal securities laws in an actual bond offering.

## I. The Federal Regulatory Framework

### A. Historical Overview

The regulation of municipal securities has traditionally been a state concern. Consequently, federal regulation of the municipal securities market has been very limited when viewed in historical terms, despite its present status as a trillion-dollar market with over 50,000 different issuers.

Both the 1933 Act and the 1934 Act were adopted with broad exemptions for municipal securities from the registration and reporting requirements made applicable to corporate securities. Though Congress did subject municipal securities to the antifraud provisions of 1933 Act Section 17(a) and 1934 Act Section 10(b), post hoc enforcement of these provisions was to be the extent of the federal government's regulation of the municipal securities market until 1975.

In that year, Congress passed the Securities Acts Amendments of 1975 (the "1975 Amendments"), which established a limited regulatory scheme at the federal level designed mainly to address abusive practices by municipal securities brokers and dealers. The 1975 Amendments mandated the registration of municipal brokers and dealers for the first time and created the MSRB to establish rules for their behavior. In addition, the 1975 Amendments divided up inspection and enforcement responsibility for the newly registered brokers and dealers among the SEC, the National Association of Securities Dealers ("NASD") and the bank regulatory agencies. Significantly, however, Congress placed no new substantive requirements on issuers of municipal securities, and in fact added two provisions to prevent the SEC and the MSRB from doing so in the future. These provisions have become popularly known as the "Tower Amendment."

Congress has not passed any legislation since the 1975 Amendments to alter the limited federal regulatory framework established at that time. Subsequent events like New York City's default in 1976 and the $2 billion default of the Washington Public Power Supply System in 1983, however, have led the SEC to take a progressively more aggressive regulatory stance.

In 1989, the SEC adopted Rule 15c2-12 under the 1934 Act, which is discussed in greater detail below. Drafted to comply with the letter if not the spirit of the Tower Amendment, this Rule put into place disclosure requirements for underwriters (and, indirectly, for issuers) to follow

in primary offerings of municipal securities. In 1994, the SEC significantly expanded its sights, adopting amendments to Rule 15c2-12 that will require municipal issuers to undertake secondary market disclosure for the first time and approving a new MSRB rule designed to limit the use of political contributions to obtain municipal underwriting business. According to SEC Chairman Levitt, reform of the municipal debt market is now one of the Commission's top priorities, its job being "to bring the market for municipal securities into the Twentieth Century before we reach the Twenty-First."

## B. Securities Act of 1933

### 1. Exemption from Registration for Municipal Securities

Section 5 of the 1933 Act provides that it is unlawful to offer or sell any security by means of interstate commerce unless a registration statement is in effect with respect to that security or an exemption is available. Section 2(1) of the 1933 Act provides that the term "security" includes "any . . . bond, debenture, [or] evidence of indebtedness . . . ." In most instances, municipal securities are exempt from the registration provisions of Section 5 of the 1933 Act pursuant to one or more clauses of Section 3(a) of the 1933 Act. Section 3(a) exempts from registration a variety of securities, either because the issuer of the securities is subject to regulation by another governmental authority, or because the securities were not thought by Congress to present a substantial risk to investors.

Most issuers of school bonds would find their exemption from registration in Section 3(a)(2): "Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities: . . . Any security issued or guaranteed by . . . the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory or by any public instrumentality of one or more States or Territories . . . or any security which is an industrial development bond . . . the interest on which is excludable from gross income under Section 103(a)(1) of Title 26 [the Internal Revenue Code] . . . ." 15 U.S.C.A. § 77c(a)(2) (West 1981).

### 2. Section 17(a) Antifraud Liability

Section 17(a) of the 1933 Act prohibits the offer and sale of securities by fraudulent means, including by material misstatements or omissions. Its language closely tracks the "catch-all" antifraud language contained in Section 10(b) of the 1934 Act. Unlike Section 10(b) and Rule 10b-5 thereunder, Section 17(a) has not been interpreted to offer a private right of action to defrauded investors. However, the Supreme Court has interpreted Section 17(a) to require only a showing of negligence to

sustain an SEC enforcement action as opposed to the higher liability standard of intentional misconduct (or "scienter") required in Section 10(b) and Rule 10b-5 actions. *Aaron v. SEC*, 446 U.S. 680, 696-97 (1980).

Congress exempted municipal securities from two other important antifraud provisions of the 1933 Act that do establish a private right of action: (i) Section 11, which prohibits material misstatements or omissions in a registration statement and (ii) Section 12(2), which prohibits such misstatements or omissions in prospectuses or oral communications.

## C. Securities Exchange Act of 1934

### 1. Section 10(b) and Rule 10b-5 Antifraud Liability

The 1934 Act, Section 10(b) makes it illegal for any "person" directly or indirectly through the mails, any instrumentality of interstate commerce or a national securities exchange "[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 under the 1934 Act expands upon the fraudulent behavior proscribed in Section 10(b), making it unlawful for any "person" (1) to employ any device, scheme or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The term "person" is defined by the 1934 Act, Section 3(a)(9) to mean "a natural person, company, government, or political subdivision, agency, or instrumentality of a government." When adopting the 1975 Amendments, Congress added the language including governments and their subdivisions in the 1934 Act definition of "person" to eliminate any doubt that Section 10(b) and Rule 10b-5 did apply to municipal issuers.

To successfully bring a civil action under Section 10(b) and Rule 10(b)-5, a private plaintiff must generally prove the following by a preponderance of the evidence:

a. Prove his status as a purchaser or seller of securities. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).
b. In the case of defective disclosure, prove that the misstatement or omission claimed was material. The generally accepted test for materiality articulated by the

Supreme Court establishes information as material "if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision." *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

c. Prove that the defendant or defendants acted intentionally or willfully, i.e., with scienter. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976). Some lower courts have held that a finding of recklessness would satisfy this requirement, though the Supreme Court has not yet ruled on this issue. *See, e.g., Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977); *Stern v. American Bankshares Corp.*, 429 F. Supp. 818 (E.D. Wis. 1977).

d. Prove that the alleged misconduct was "in connection with" the purchase or sale of a security. This amounts to a showing that the action taken was related to and reasonably contemporaneous with the purchase or sale. *Superintendent of Life Insurance v. Bankers Life and Casualty Co.*, 404 U.S. 6 (1971).

e. Prove reliance by the plaintiff, in the case of material misstatements, on the incorrect information. In the case of alleged material omissions where proving reliance would be impossible, reliance is presumed (though subject to rebuttal by the defendant) after materiality is established. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972). A plaintiff may also establish a rebuttable presumption of reliance by invoking the "fraud on the market theory." This theory essentially holds that, in active markets, most publicly available information becomes factored into the price of a given security, and that most investors who trade at a price set by the market do so in reliance upon the integrity of that price. *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Some commentators have questioned whether this theory would be applicable in the municipal securities market, which is notably less efficient than the markets for corporate securities. *See, e.g.*, Amdursky and Gillette, *Municipal Debt Finance Law: Theory and Practice*, 365 (1992).

f. In cases involving alleged material nondisclosure, prove that the defendant had a duty to disclose the informa-

tion, whether by virtue of a legal requirement to do so, a fiduciary relationship between the plaintiff and the defendant or previous disclosures made by the defendant. Mere possession of non-public information does not give rise to a duty to disclose, so silence in the absence of such a duty is not actionable under the federal securities laws. *See Chiarella v. United States*, 445 U.S. 222 (1980); *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988). Courts have held that no general duty exists to update previous disclosure that was accurate at the time made (e.g., in an official statement), though there may be a duty to correct previous disclosure that was inaccurate at the time made. *See Backman v. Polaroid Corp.*, 910 F.2d 10 (1st Cir. 1990). *See also* Schneider, *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?* 23 Sec. & Comm. Reg. 9 (May 9, 1990). Proving this element of a civil action may become one of the plaintiff's easier tasks after the new amendments to Rule 15c2-12 take effect and require issuers and obligated persons to contractually obligate themselves to continuing disclosure.

g. Prove actual damage as a result of the defendant's misconduct. Only compensatory, not punitive, damages are typically allowed. The traditional measure of damages in a Section 10(b) action is out-of-pocket loss. *Hackbart v. Holmes*, 675 F.2d 1114 (10th Cir. 1982). In some cases, however, a benefit of the bargain measure may be appropriate. *Id.*

**2. 1988 and 1989 SEC Releases Regarding Municipal Securities Disclosure**

In the aftermath of the Washington Public Power Supply System default, the SEC staff conducted an investigation into its causes and ultimately determined that the underwriters involved with the offerings did not conduct an adequate examination of the issuer's disclosure made to investors at the time of sale of the bonds. *See Securities and Exchange Commission Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities* (1988). This investigation prompted the SEC to review the status of municipal securities disclosure and ultimately led to the adoption in 1989 of SEC Rule 15c2-12 governing the delivery of official statements in primary offerings.

The SEC issued separate releases proposing Rule 15c2-12 (Release No. 34-26100, Sept. 22, 1988, hereinafter the "1988 Release") and adopt-

ing Rule 15c2-12 (Release No. 34-26985, June 28, 1989, hereinafter the "1989 Release"). The 1988 Release and 1989 Release are important not only for their explanation of Rule 15c2-12, discussed in Part II below, but also because they provide the most extensive discussion to date of the SEC's view of the legal obligations of municipal underwriters under the antifraud provisions of the federal securities laws.

In the 1988 Release, the SEC stated its belief that the antifraud provisions and the duty of fair dealing imposed upon brokers and dealers by the securities laws require a municipal underwriter to have a reasonable basis for recommending any municipal security. When an underwriter supplies disclosure documents to investors, it makes an implied representation that it has a reasonable basis for belief in the truthfulness and completeness of the key representations contained therein.

The 1988 Release goes on to state that, in both negotiated and competitively bid municipal offerings, underwriters at a minimum should review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions. Beyond this basic review, the extent of underwriter diligence required to obtain a reasonable basis for recommending an issuer's securities depends on the particular circumstances involved. The SEC went on to list the following factors relevant to the extent of underwriter diligence required: the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts; the type of underwriting arrangement (e.g., firm commitment or best efforts); the role of the underwriter (manager, syndicate member, or selected dealer); the type of bonds being offered (general obligation, revenue, or private activity); the past familiarity of the underwriter with the issuer; the length of time to maturity of the bonds; the presence or absence of credit enhancements; and whether the bonds are competitively bid or are distributed in a negotiated offering. 1988 Release, 4 Fed. Sec. L. Rep. (CCH) at 18, 183-88.

The 1988 Release states that in negotiated municipal offerings where the underwriter is involved in the preparation of the official statement, obtaining a reasonable basis for recommendation should involve a professional inquiry into the key representations in the official statement, drawing on the underwriter's experience with the particular issuer, and other issuers, as well as its knowledge of the municipal markets. Reliance solely on the representations of an issuer, the 1988 Release notes, does not suffice. *Id.*

With respect to competitively bid municipal offerings, the 1988 Release indicates that underwriting on such a basis does not negate the responsibility of the underwriter to perform a reasonable review despite

the fact that municipal underwriters may have little initial access to information concerning securities that have been bid on a competitive basis. In the Commission's view, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement for a competitive offering if it reviewed the official statement in a professional manner, and received from the issuer a credible and detailed explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information otherwise available to the underwriter, to be inadequate. *Id.*

In the 1989 Release, the SEC addressed concerns raised by the 1988 Release. The SEC acknowledged that while the focus of the prior release was on activities of underwriters, the primary responsibility for disclosure still rests with the issuer of the securities. Because issuers are ultimately liable for the content of their disclosure, the SEC added that issuers should insist that any persons retained to help in the preparation of their disclosure documents have a professional understanding of the disclosure requirements under the federal securities laws. The SEC also makes the point that, by issuing the 1988 Release and the 1989 Release, it did not view itself as creating any new standards of liability from those articulated by the current statutes and case law. Finally, the 1989 Release emphasizes that the presence of credit enhancement does not foreclose the need for a reasonable investigation of the accuracy and completeness of key representations concerning the primary obligor. 1989 Release, 4 Fed. Sec. L. Rep. (CCH) at 18,199-10 through 18,200.

**3. 1994 SEC Release Regarding Municipal Securities Disclosure**

In 1994, concurrent with publication of the proposed amendments to Rule 15c2-12, the SEC issued a release (Release Nos. 33-7049, 34-33741, Mar. 9, 1994, hereinafter, the "1994 Release") articulating its interpretation of the antifraud provisions of the federal securities laws. The 1994 Release focuses particularly on the disclosure obligations of municipal issuers. The major points addressed by the SEC are set forth below.

**a. *Relationships.***

In the 1994 Release, the SEC highlights its concern about potential conflicts and problems which may arise as a result of the relationships and arrangements among parties to a financing. The SEC does not provide explicit guidance concerning what is to be disclosed, but does state that information "concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering. Recent revela-

tions about practices used in the municipal securities offering process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. . . . Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. . . . Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case."

**b. *Derivatives.***

The 1994 Release also highlights disclosure needed to be made with respect to "increasingly complex and sophisticated derivative and other municipal products." The 1994 Release states that, "While these new products offer investors a wide range of investment alternatives, in choosing among the alternatives, investors need a clear understanding of the terms and the particular risks arising from the nature of the products."

**c. *Credit Enhancement.***

With respect to credit enhancement, the 1994 Release notes, seemingly with approval, the Government Finance Officers Association's recommendation that "appropriate" financial information be included in the official statement, including information about the assets, revenues and results of operations of credit enhancers. The SEC states that, in determining the extent of disclosure, "consideration should be given to the amount of the enhancement relative to the income and cash flows of the issuer or obligor, conditions precedent to application of the enhancement, duration of the enhancement, and other factors indicating a material relationship between the enhancement and the investor's anticipated return."

**d. *Statement Concerning Ongoing Disclosure.***

Because issuers in the municipal market routinely make public statements and issue reports that can affect the market for their securities, the SEC states in the 1994 Release that without a mechanism for providing ongoing disclosures to investors, these disclosures may cause the issuer to violate the antifraud provisions of the securities laws. It then goes on to list basic ways of preventing potential antifraud liability including: (i) publication of financial information, including audited financial state-

ments and other financial and operating information, on at least an annual basis; (ii) timely reporting of material events reflecting upon the creditworthiness of the issuer or the obligor and the terms of its securities, including material defaults, draws on reserves, adverse rating changes and receipt of an adverse tax opinion; and (iii) submission of such information to an information repository. The 1994 Release also states, "The official statement should state clearly whether ongoing disclosure concerning the issuer or obligor will be provided, including the type, timing and method of providing such information." It goes on to say, "In order to fully inform investors, an issuer needs to include in the official statement a description of the scope of its continuing disclosure commitment, the type of information that would be provided, the repositories to which the information would be sent, when annual and other periodic information would be available, and the consequences of the issuer's failure to abide by the requirements of the covenant."

**e. *Conduit Issues.***

The SEC, in the 1994 Release, renews its support for legislation to remove the registration exemption for the corporate credit underlying municipal conduit securities involving nongovernmental industrial development (private activity) financings. However, in view of reality, the SEC states, "pending amendment" of the law, "the disclosure provided by such non-governmental conduit borrowers should be substantially the same as if such conduit borrowers were subject to the information requirements of the federal securities laws applicable to the particular conduit borrower."

**f. *Frequent Issuers.***

In its discussion of the ongoing disclosure requirements, the SEC refers to the need to prepare and distribute, at least, annual financial reports. The 1994 Release does, however, note that "for frequent issuers, current information can be disseminated in official statements for new offerings, and thus is readily available without the preparation of a separate annual financial report."

**4. The Tower Amendment**

At the time the 1975 Amendments were proposed, municipal issuers expressed concern over the possibility that the legislation would permit indirect requirements to be imposed by the SEC or the MSRB requiring municipal dealers to secure certain types of information regarding municipal issuers. In specific, "the fear [was] expressed that requirements could be imposed which would have the effect of subjecting the information disclosed by issuers in connection with an offering to prior re-

view or approval, thus resulting in a *de facto* registration requirement for municipal bonds." S. Rep. No. 75, 94th Cong., 1st Sess. 119 (1975).

Attempting to put these concerns to rest, Congress added two provisions to the legislation, found at Sections 15B(d)(1) and (2) of the 1934 Act, that have become known collectively as the "Tower Amendment." Section 15B(d)(1) prohibits either the SEC or the MSRB from requiring any municipal issuer, directly or indirectly through a purchaser or potential purchaser of the Issuer's securities, to file with the SEC or the MSRB prior to the sale of such securities any application or other document in connection therewith. Section 15B(d)(2) prohibits the MSRB from requiring any municipal issuer, directly or indirectly through a municipal securities broker or dealer or otherwise, to furnish to the MSRB or to purchasers or potential purchasers of the issuer's securities any report, application, document or information concerning such issuer.

Section 15B(d)(2) also contains a caveat. The MSRB may require municipal brokers and dealers to provide to it or purchasers of municipal securities information with respect to the issuer thereof that is generally available from sources other than the issuer. Taken as a whole, the Tower Amendment was meant to protect the special status granted to municipal securities under the 1933 Act and the 1934 Act, and ensure against the imposition of de facto registration requirements for issuers of municipal securities which would interfere with their ability to borrow in the capital markets. *Id.* at 119. Given the SEC's new regulatory posture, however, the extent to which the Tower Amendment still performs this function is now in doubt.

## II. SEC Rule 15c2-12– Primary Market Regulation

The SEC announced the adoption of current Rule 15c2-12 in the 1989 Release. Rule 15c2-12 makes it "unlawful" for any broker, dealer or municipal securities dealer (defined as a "Participating Underwriter") to act as an underwriter in a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more unless the Participating Underwriter complies with Rule 15c2-12 or is exempted. The effect of the Rule is to indirectly impose a requirement on most municipal issuers to deliver a substantially final official statement to underwriters before they can issue their bonds. The provisions of Rule 15c2-12 as currently in effect are briefly discussed in this Part II. Such provisions apply to offerings in the primary market. The SEC, on November 10, 1994, adopted amendments to Rule 15c2-12 that will become effective July 3, 1995, as discussed in Part III below.

## A. Requirement to Obtain and Review "Deemed Final" Official Statement.

Before bidding for, purchasing, offering or selling municipal securities, a Participating Underwriter must obtain and review a "deemed final" official statement from an "issuer" (see the discussion of "issuer" below) of the securities. A "deemed final" official statement may exclude only the following information: offering prices, interest rates, selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, terms required to be specified in a competitive bid, ratings, other terms depending on such matters and the identity of the underwriters. With the exception of the above information, the official statement reviewed by the Participating Underwriter must be "deemed final" by an issuer.

For competitively bid securities, Rule 15c2-12 requires the Participating Underwriter to review the disclosure documents before bidding. Thus, issuers are required to produce the "deemed final" official statement (which need not be one bound document, but may be, for example, a prior official statement supplemented with updated disclosure and information on the current offering) before bidding. For negotiated offerings, the Rule requires the Participating Underwriter to review the "deemed final" document before the earlier of the time it executes the bond purchase agreement or the first sale of the securities.

The decision as to whether an official statement is "deemed final" except for the permitted exclusions is made by an issuer of the securities. Under the Rule, an "issuer" is the governmental issuer and the issuer of any "separate security," which includes the issuer of a letter of credit or "the lessee or obligor on payments to be made in respect of property or money which is or will be used, under a lease, sale or loan arrangement, by or for industrial or commercial enterprise, which payments will be used to make payments on the governmental securities." Thus, in a conduit offering, both the government unit actually issuing the securities and the conduit borrower can be considered an "issuer."

Designation of a document as "deemed final" is not intended to imply that further amendment may not be required following review by the Participating Underwriter. The Commission took pains to note in the 1989 Release that "disclosure is a dynamic process and even substantial changes to the ['deemed final' official statement] may be necessary to comply with the federal securities laws." The Commission also stated in the 1989 Release that the Rule "need not prevent an underwriter from bidding on an issuer's securities in a competitive offering, even when it determines that disclosure problems exist, so long as the underwriter receives assurances that the disclosure will be corrected." The SEC also encouraged

underwriters to include in the underwriting agreement the ability to correct inaccurate or incomplete disclosure.

### B. Distribution of Preliminary Official Statements.

The Rule requires, except in competitively bid offerings, that a Participating Underwriter send a single copy of the most recent preliminary official statement, if any, to any "potential customer" on request. The Rule does not require the preparation of a preliminary official statement, only its distribution if one is produced. A "preliminary official statement" is defined as a document that is prepared for dissemination to potential customers before the availability of the final official statement. It need not be the "deemed final" official statement (although in practice it usually is).

### C. Requirement to Contract to Receive Copies of Final Official Statements.

The Rule also requires a Participating Underwriter to contract with an issuer or its agent to receive, within seven business days after any final agreement to purchase, offer or sell securities and in sufficient time to accompany any confirmation requesting payment from any customer (a "money confirmation"), sufficient copies of a final official statement to comply with the Rule and any rules of the Municipal Securities Rulemaking Board (the "MSRB"). The Commission stressed the need to facilitate the prompt distribution of disclosure documents and noted that compliance with MSRB rules is "often relegated to a low priority by underwriters."

Apart from requiring that final official statements be obtained by the Participating Underwriter within seven days of the bond purchase agreement and in sufficient time to accompany or precede any money confirmation, Rule 15c2-12 leaves determination of the precise method and timing of delivery to the MSRB, which currently requires that underwriters provide each investor a copy of the final official statement no later than settlement.

A final official statement is defined by the Rule as an official statement which is complete as of the date of delivery of the document or set of documents to the Participating Underwriter. As with the "deemed final" official statement, a final official statement may consist of more than one document.

### D. Requirement to Provide Copies of Final Official Statements to Potential Customers.

An additional requirement of the Rule is that Participating Underwriters provide copies of any final official statement to any potential

customer, on request, during specified time periods. The Participating Underwriter's obligation to deliver final official statements extends for a maximum of ninety days following the "end of the underwriting period," the beginning of which is defined as the later of the time the issuer delivers the securities to the Participating Underwriters and the time at which the Participating Underwriter does not retain, directly or as a member of an underwriting syndicate, an unsold balance of securities to be sold to the public. The ninety-day period is shortened to twenty-five days if the Participating Underwriter files the final official statement with a "nationally recognized municipal securities information repository" (an "NRMSIR"). (NRMSIR's are private organizations, approved by the SEC, which for a fee will provide to broker-dealers, institutional investors and others copies of official statements and other information filed with them by issuers. There are currently four NRMSIR's.)

### E. Exemptions.

The SEC noted that the Rule is not intended to restrict access to the capital markets, but recognized that some of the technical requirements of the Proposed Rule may have prevented transactions which are efficient and in which the need for disclosure protections is not as great. Thus, the SEC created exemptions from the Rule for certain offerings of securities. To qualify for any of the specified exemptions, the securities must be offered in authorized denominations of $100,000 or more (which figure may be adjusted to take into account original issue discount of ten percent or more).

Securities in such denominations will be exempt from the requirements of the Rule in three instances: (1) if such securities are sold to no more than thirty-five persons, each of whom is a sophisticated investor purchasing for only one account and not with a view to distribution (all in the reasonable belief of the Participating Underwriter); (2) if such securities have a maturity of nine months or less; or (3) if the securities may be tendered for redemption or purchase at par at least as frequently as every nine months.

## III. SEC Rule 15c2-12 and Rule 2a-7–Ongoing Disclosure Regulation

### A. 1994 Amendments to Rule 15c2-12.

The SEC published for comment in March 1994, several proposed amendments to Rule 15c2-12 primarily aimed at improving secondary market disclosure. The proposed amendments were the subject of extensive comment by members of the municipal finance industry. The SEC, upon review of the comments and in consultation with a group of indus-

try participants, revised the proposed amendments and on November 10, 1994, adopted, in final form, amendments to Rule 15c2-12 which, through commitments required to be obtained at the time of the primary offering of bonds, regulate the dissemination of information on an ongoing basis.

The amendments, as adopted, generally provide that, in addition to the requirement imposed upon underwriters by the original provisions of Rule 15c2-12, it shall also be unlawful for an underwriter to purchase or sell municipal securities in connection with an offering unless the underwriter has reasonably determined that an issuer of municipal securities or obligated person for whom financial or operating data is presented in the final official statement has undertaken, either individually or in combination with other issuers or obligated persons, in a written agreement "for the benefit of the holders" of the bonds to provide either directly or indirectly through an indenture trustee or a designated agent:

1. To each NRMSIR and to the appropriate state information depository,[1] if any, annual financial information for each obligated person for whom financial information or operating data is presented in the final official statement, or, for each obligated person meeting the objective criteria specified in the agreement of the issuer or obligated person;
2. If not submitted as part of the annual financial information, then when and if available, to each NRMSIR and to the appropriate state information depository, audited financial statements for each obligated person described in A above;
3. In a timely manner, to each NRMSIR or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of any of the following events with respect to the bonds, if material ("Material Event Disclosure"):

a. Principal and interest payment delinquencies;
b. Non-payment related defaults;
c. Unscheduled draws on debt service reserves reflecting financial difficulties;
d. Unscheduled draws on credit enhancements reflecting financial difficulties;
e. Substitution of credit or liquidity providers, or their failure to perform;

[1] Each state may, but is not required to, set up a state information depository which would contain information filed by issuers and obligated persons in that state.

f. Adverse tax opinions or events affecting the tax-exempt status of the security;
g. Modifications to rights of security holders;
h. Bond calls;
i. Defeasances;
j. Release, substitution, or sale of property securing repayment of the securities; and
k. Rating changes; and

4. In a timely manner, to each NRMSIR or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, notice of a failure to provide required annual financial information (as described in A above), on or before the date specified in the written agreement or contract.

The rule will require that the written agreement or contract for the benefit of holders of the bonds identify each person for whom annual financial information and notices of material events will be provided, either by name or by the objective criteria used to select such persons, and, for each such person shall:

a. Specify, in reasonable detail, the type of financial information and operating data to be provided as part of annual financial information; and
b. Specify, in reasonable detail, the accounting principles pursuant to which financial statements will be prepared, and whether the financial statements will be audited.

What is contemplated is, in general, that the financial and operating information in the final official statement will be updated on an annual basis. Amended Rule 15c2-12 does not require that the annual information include any narrative discussion or any date of a type not in the official statement. However, the SEC in its Release adopting the amendments did remind issuers that under the antifraud rules they need to be careful to make sure that required disclosures are not misleading, and in many cases this will mean that additional information must be supplied.

The amendments to the Rule, as originally proposed, prohibited broker-dealers from purchasing or selling securities unless the broker-dealer had received the information that the issuer had agreed to provide. In the face of serious and widespread concerns of the industry, the

SEC removed this provision and, the Rule, as implemented, provides, instead, that it shall be unlawful for any broker, dealer, or municipal securities dealer to recommend the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has procedures in place that provide reasonable assurance that it will receive prompt notice of any material event disclosed as described in C above, any failure to provide information and of the filing of audited financial statements with respect to that security.

**B. Effective Date.**

The amendments to Rule 15c2-12 relating to ongoing disclosure apply to all bond issues for which any underwriter contractually commits to act as an underwriter on or after July 3, 1995; however, issuers need not undertake to provide annual financial information for fiscal years ending prior to January 1, 1996.

**C. Exemptions.**

In addition to the other exemptions from Rule 15c2-12 discussed at the end of Part II above, the Rule exempts from the annual reporting provisions (but not from Material Event Disclosure) municipal securities with a stated maturity of eighteen months or less. The amendments also provide that the ongoing reporting requirements shall not apply to an offering of municipal securities if, at such time as an issuer of such municipal securities delivers the securities to the participating underwriters:

1. No obligated person will be an obligated person with respect to more than (with certain exceptions) $10,000,000 in aggregate amount of outstanding municipal securities, including the offered securities;
2. An issuer of municipal securities or obligated person has undertaken, either individually or in combination with other issuers of municipal securities or obligated persons, in a written agreement or contract for the benefit of holders of such municipal securities, to provide:

a. *Upon request* to any person or at least annually to the appropriate state information depository, if any, financial information or operating data regarding each obligated person for which financial information or operating data is presented in the final official statement, as

specified in the undertaking, which financial information and operating data shall include, at a minimum, that financial information and operating data which is customarily prepared by such obligated person and is publicly available; and

b. In a timely manner, to each NRMSIR or to the Municipal Securities Rulemaking Board, and to the appropriate state information depository, if any, any Material Event Disclosure; and

3. The final official statement identifies by name, address, and telephone number the persons from which the foregoing information, data, and notices can be obtained.

### D. Proposed Amendments to Rule 2a-7.

The SEC has not limited its efforts to improve secondary market disclosure to the Rule 15c2-12 amendments. The SEC has also proposed amendments to Investment Company Act Rule 2a-7 governing tax-exempt money market funds that would, if adopted, apply indirect pressure on municipal issuers to provide ongoing secondary market disclosure. The proposed amendments to Rule 2a-7, subject to certain limited exceptions, would require the managers of such funds to dispose of the tax-exempt securities in their portfolio that are subject to a put or demand feature (usually these securities are variable rate obligations) in any case where ongoing financial disclosure is unavailable from the issuer thereof. Revisions to Rules Regulating Money Market Funds, Securities Act Release No. 7038, Investment Company Act Release No. 19959, [1993-1994 Transfer Binder] Fed. Sec. L. Rep. (CCCH) 84,958 (Dec. 17, 1993).

## IV. MSRB Rule G-37 Regulating Political Contributions to Municipal Issuers

The SEC recently gave final approval to MSRB Rule G-37, which seeks to regulate political contributions to municipal issuers by brokers, dealers and other "municipal finance professionals" as defined by the Rule.

According to the SEC, Rule G-37 seeks to address the real as well as perceived abuses resulting from "pay to play" practices in the municipal securities industry. The Rule sets forth several separate requirements (described briefly below) affecting municipal securities dealers, including limitations on business activities due to political contributions, limitations on solicitation of political contributions and dealer record keeping and disclosure.

### A. Business Disqualification Provisions.

Rule G-37 prohibits municipal brokers and dealers ("broker-dealers") from engaging in municipal securities business with an issuer within two years after proscribed contributions made by (1) the broker-dealer, (2) any municipal finance professional associated with the broker-dealer or (3) any political action committee controlled by the broker-dealer, to an official of the issuer who can, directly or indirectly, influence the awarding of municipal securities business.

The Rule exempts contributions of $250 or less per election to each official for whom a municipal finance professional is entitled to vote. In addition, the Rule was recently amended to allow hardship exemptions to be made on a case-by-case basis for inadvertent violations of its requirements.

### B. Solicitation and Bundling Restrictions.

Rule G-37 also prohibits broker-dealers and municipal finance professionals from soliciting contributions on behalf of officials of issuers with which the broker-dealer is engaging or seeking to engage in municipal securities business or to coordinate (i.e., bundle) contributions. This is intended to prevent broker-dealers from engaging in municipal securities business with issuers if they engage in any kind of fund-raising activities for officials of the issuers that may influence the underwriter selection process.

### C. Record Keeping Requirements.

The Rule also includes a requirement for quarterly reporting by broker-dealers of certain information regarding political contributions and municipal securities business engaged in to the MSRB, which intends to make the information publicly available. Additionally, complementary amendments to previously existing MSRB Rules G-8 and G-9 on record keeping and record retention, respectively, were also made.

The constitutionality of Rule G-37 is presently being challenged on First Amendment grounds by an Alabama broker-dealer who also holds office with the state Democratic party.

## V. Practical Applications

### A. Offering of Bonds

This section of this paper will attempt to briefly sketch how a school issuer (an "Issuer") and the other parties involved in a school bond issue go about meeting the requirements of the federal securities laws outlined in previous sections.

The primary focus of meeting the Issuer's disclosure obligations is the Issuer's official statement. The Issuer, or more often the Issuer's financial adviser or disclosure counsel, will prepare the official statement, with the aid of the Issuer's bond counsel and, in a negotiated issue, the managing underwriter and its counsel. However, regardless of who prepares the official statement, the Issuer is responsible for the information in it (other than information about certain third parties, such as a bond insurer). First, a preliminary official statement will be prepared, which will normally be the "deemed final" official statement for purposes of Rule 15c2-12. It will be made available to potential bidders if the bonds are to be sold by public bid or, if the sale is negotiated, will be used by the underwriter to solicit interest in the bonds by potential purchasers. Once the winning bid has been accepted or the underwriter of a negotiated issue has signed an agreement to purchase the bonds, the Issuer will prepare a final official statement for delivery to investors by the underwriters. The final official statement will be likely to be identical to the preliminary official statement, except that interest rates and other items that could not be known until the bonds were marketed will be filled in and any material events that have occurred since the date of the preliminary official statement will be described.

As noted previously, Rule 10b-5 under the 1934 Act prohibits the Issuer from intentionally or recklessly making any untrue statement of a material fact or omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, in connection with the sale of its bonds. Moreover, amended Rule 15c2-12 requires that a final official statement set forth "information concerning the terms of the proposed issue of securities; information, including financial information or operating data, concerning such issuers of municipal securities and those other entities, enterprises, funds, accounts, and other persons material to an evaluation of the Offering." The Issuer and its financing team (financial adviser, counsel, bond counsel and others taking part in the financing) will therefore spend a good deal of time and effort making sure that the preliminary official statement contains all facts about the Issuer and the bond issue which an investor would want to know before purchasing the bonds. Although financial advisers and counsel will do most of the drafting, it is important that knowledgeable officials of the Issuer review the official statement carefully. Bond counsel will usually prepare the portions of the official statement which describe the bonds and the bond resolution or trust indenture pursuant to which they are issued, and will usually give at closing an opinion to the Issuer and underwriters that such descriptions are accurate. If bond insurance or other credit enhancement is

being obtained for the issue, the credit enhancer will supply a description of itself for inclusion in the official statement. In a negotiated issue, the underwriter and its counsel will also review and comment on drafts of the official statement as it is developed and will conduct a "due diligence investigation," interviewing Issuer officials and gathering information, in order to assure themselves that they have a reasonable basis for believing the statements in the official statement.

There are no hard and fast rules for determining what information is material and should be included in official statements. For general guidelines, counsel and financial advisers look to past official statements by the Issuer and other similar issuers, guidelines prepared by industry groups such as the Government Finance Officers' Association, *Disclosure Guidelines for State and Local Government Securities* (1991) and the National Federation of Municipal Analysts *Disclosure Handbook for Municipal Securities, 1992 Update* (1992) (both of which are referred to with approval by the SEC in the 1994 Release) and the SEC's 1989 and 1994 Releases. Audited financial statements of the Issuer should be included.

When the preliminary official statement is complete, it should contain all material facts about the bond issue except for those items that cannot be determined until the bonds are marketed. These are the same items that Rule 15c2-12 allows to be left out of the "deemed final" official statement, i.e., the offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, other terms of the securities depending on such matters, and the identity of the underwriter(s). The Issuer will usually certify in the notice of sale or preliminary official statement (or in a separate certificate in a negotiated issue) that the preliminary official statement is deemed final as of its date except for the permitted exclusions. Among the items often required to be specified in a competitive bid or which, in a negotiated sale, will not be decided until the bonds are offered, is whether or not the bonds are to be insured and, if so, by which insurer. The SEC has stated in a no-action letter that under these circumstances the "deemed final" official statement need not describe the bond insurer and bond insurance, but should give what information can be given, e.g., that the bonds may be insured, any minimum requirements for the insurance, etc.

Once a winning bid is accepted in a publicly bid sale or after the underwriter has marketed the bonds in a negotiated sale, the Issuer and the underwriter or underwriters (often more than one underwriter will join together to bid for or market a bond issue, in which case a "managing" or "senior managing" underwriter will represent all the underwrit-

ers) will sign a purchase agreement. Pursuant to Rule 15c2-12 this agreement must require the Issuer to deliver final official statements to the underwriter within seven business days. The final official statement will usually be substantially the same as the preliminary official statement, but with the interest rates and other missing information filled in. In addition, the Issuer must add a discussion of any material events that have occurred since the date of the preliminary official statement. These events should be highlighted in a separate section or, for very important items, in a separate "sticker" attached to the front cover of the final official statement.

MSRB rules require the underwriters to deliver the final official statement to a customer before requesting payment. For that reason and to permit bond counsel to complete preparations for closing, there will usually be a period of one or two weeks or more between signing the purchase agreement and the closing of the bond issue. During the period between delivery of the final official statement and closing the Issuer must remain alert to material developments regarding its creditworthiness and the bond issue. If a material event occurs, the underwriters must be informed and a supplement to the final official statement must be prepared.

Some disclosure responsibilities may continue even after the bonds are delivered and paid for at closing. If a material mistake in the official statement is discovered, this must be disclosed to the underwriters and a supplement to the official statement prepared. The same may be true if a "forward looking" statement in the official statement turns out to be wrong and the market can be expected to still be relying on it. In addition, underwriters will often insert in bond purchase agreements a covenant to inform them of any material developments for a specified period of time after closing, during which they may still be selling some of the bonds. Typically this coincides with the time period during which they are required to continue delivering final official statements to customers under Rule 15c2-12.

## B. Continuing Disclosure

As discussed above, the adopted amendments to Rule 15c2-12 effectively require issuers to undertake formal programs of providing ongoing disclosure to the market. The SEC's view, based on corporate securities case law, is that if an issuer (as part of such formal program or otherwise) does make statements to the market, or statements which are not made explicitly to the market but can be expected to reach the market, it must be sure there are no material misstatements or omissions in such statements. For offerings subject to Rule 15c2-12, both continuing

disclosure of the material events stipulated by the Rule and annual financial information is required. The final official statement for a given transaction will set the standard for the ongoing disclosure relating to that transaction. The final official statement must describe in detail the scope of each undertaking to provide ongoing disclosure and identify the parties making the undertakings. According to the SEC release accompanying the Rule's adoption, the financial information and operating data to be provided on an annual basis should "mirror" the financial information and operating data set forth in the final official statement with respect to the obligated persons covered by the undertaking. Neither the Rule nor such release, however, specifies or defines, with limited exceptions, the financial information or operating data to be provided or the content of the final official statement. Determining the content of the final official statement and the parts of it that will be updated annually is left to the parties involved in the initial offering. In this regard, the SEC recommends the use of voluntary industry disclosure guidelines, such as those of the Government Finance Officers Association, and the SEC's own March 1994 Interpretive Release, in preparing an official statement while reminding all parties that the antifraud provisions under the securities laws apply to municipal transactions. Given that issuers do have the ability under the Rule to designate the extent of their continuing disclosure obligations with respect to any particular bond offering at the time of initial issuance and that these obligations may not be modified after such time, issuers and their counsel should give very serious consideration to the general type and amount of information they choose to include in their official statements. Only information that is truly material to an evaluation of the offering should be included, and issuers should ensure that they have procedures in place to collect for annual dissemination all information that they obligate themselves to provide under the Rule.

Another ongoing disclosure problem that may be faced by many issuers is how to respond to questions from brokers or from institutional investors. Some issuers are worried that if they give information to one investor that is not available generally in the market they may face insider trading liability. This concern is mostly unwarranted. Insider trading liability arises when the person giving out the information is not authorized to do so and misappropriates the information (i.e., steals it for personal gain of some sort) or has a fiduciary or similar obligation to those with whom the person getting the information might trade securities.

An issuer cannot misappropriate information from itself and has no fiduciary obligation to its bondholders. Accordingly, insider trading liability is unlikely to arise, as long as the issuer or its employee doing the disclosing do not derive a profit from any trading the receiver of the

information might do. It is, in fact, not clear that an issuer of bonds can incur insider trading liability even if it does benefit from the trades, but the unfairness of such acts causes one to believe the SEC would attempt to find a way to prohibit it. (*See* Harvey L. Pitt & Karl A. Groskaufmenis, *A Tale of Two Instruments: Insider Trading in Non-Equity Securities*, THE BUS. LAW., Nov. 1993). The real issue in responding to analysts questions is, again, whether or not the responses are accurate and whether information not asked for needs to be included in the response to keep it from being misleading. Another issue is simply one of fairness. If an institutional investor submits a questionnaire, the issuer may well feel that if it is going to supply this sort of comprehensive information to one investor it should file it with an NRMSIR and make it available to all.

## C. Insider Trading

Insider trading can occur in the municipal market. An employee, consultant or investment banker in possession of information obtained from the issuer that if disclosed would change the price of an outstanding bond cannot buy or sell that bond, or tip off others who would buy or sell the bond, unless that information is disclosed to the market. Thus, for example, if an issuer is planning to advance refund an issue of outstanding bonds (which would result in the outstanding bonds being secured by an escrow fund of U.S. government securities and, therefore, probably significantly increasing in value), the issuer employees who are aware of the financing should be warned that they may not purchase these outstanding bonds.

### FURTHER READING

A more in-depth discussion of many of the issues discussed in this paper, along with copies of many of the SEC Releases discussed, can be found in *Disclosure Roles of Counsel in State and Local Government Securities Offerings* (2d ed. 1994), published by the American Bar Association, from a project sponsored by the Subcommittee on Municipal and Governmental Obligations, Committee on Federal Regulation of Securities, ABA Section of Business Law, the ABA Section of Urban, State, and Local Government Law and the National Association of Bond Lawyers.

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